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Enhancing welfare by attacking anticompetitive market distortions

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Enhancing welfare by attacking anticompetitive market distortions ("ACMDs")

Abstract

"Anticompetitive market distortions," or "ACMDs," involve government actions that empower certain private interests to obtain or retain artificial competitive advantages over their rivals be they foreign or domestic, to the detriment of consumer welfare. This article assesses the nature of ACMDs, and the problems governmental and international institutions (in particular, the World Trade Organization and national competition agencies) have had in dealing with them. We suggest that the multilateral International Competition Network – and, in particular, the ICN's Advocacy Working Group – may be a possible near term vehicle for beginning to confront,or at least beginning to highlight, the harm of ACMDs. With that in mind, this article proposed the development of a metric to estimate the net welfare costs of ACMDs. Such a metric could help strengthen the hand of the ICN – and of reform-minded public officials – in building the case for the dismantling these restraints, or their replacement by less costly means for benefiting favored constituencies.

Les distorsions de concurrence d'origine étatique permettent à des opérateurs privés d'obtenir ou de conserver des avantages artificiels sur leurs concurrents, étrangers ou nationaux, au détriment du bien-être des consommateurs. Cet article étudie la nature de ces pratiques et les difficultés que rencontrent les autorités de concurrence, nationales ou internationales, (en particulier l'Organisation Mondiale du Commerce) pour les appréhender. Les auteurs appellent le Réseau International de Concurrence - et en particulier le groupe de travail Advocacy - à constituer un moyen de lutte contre ces pratiques, en les mettant dans un premier temps en évidence. L'article propose l'élaboration d'un système permettant de calculer les coûts sociaux découlant de ces distorsions de concurrence. Un tel système permettrait au RIC et aux responsables politiques sensibles à une telle réforme de démanteler ces restrictions, ou du moins de les remplacer par des pratiques moins coûteuses.

I. Introduction

1. Trade policy and competition policy, properly applied, are welfare-enhancing complements. Changes to trade laws and regulations that reduce or eliminate national barriers to trade and investment (such as high tariffs, quotas, and investor nationality restrictions) promote welfare-enhancing contractual relations that expand trade and, more generally, raise aggregate welfare in the liberalizing nations[1]. The benefits of trade liberalization are magnified by competition law rules that lower the incidence of consumer welfare-reducing restrictions on the competitive process[2].

2. Unfortunately, trade law and competition law too often work at cross purposes. Well-organized domestic interests – domestic import-competing businesses, related unions, or both – may be able to organize to support trade regulations that restrict imports, often based on fallacious mercantilist arguments that imports "destroy jobs" and therefore "harm" the domestic economy. Those trade regulations dampen competition from foreign producers and harm consumer welfare, thereby undermining the goals of competition law. Obvious examples are quotas and the "anti-dumping" and "countervailing duty" laws[3] which lead government to raise industry-specific tariffs and therefore prices to domestic consumers at the behest of particular domestic business and labor interests, promoting narrow producer interests at the expense of broad-based consumer welfare. It is not just trade restrictions and regulations that can lead to consumer welfare damaging outcomes. There are a host of regulatory barriers which we will discuss here that can lead to welfare damage.

3. Properly implemented, however, trade law should raise consumer welfare and thereby work in harmony with competition law. Contrary to the protectionist impulse, in the post-World War II era the General Agreement on Tariffs and Trade (GATT) negotiating framework, and its successor, the World Trade Organization (WTO), have substantially reduced tariffs and non-tariff trade barriers, promoting

1 On the welfare benefits of trade liberalization, *see generally* OECD, Benefits of Trade Liberalization (accessed April 12, 2011), *available at* http://www.oecd.org/about/0,3347,en_2649_36442957_1_1_1_1_1,00.html. Technical questions regarding the welfare effects of specific trade liberalization policies (such as whether the welfare benefits due to "trade creation" associated with bilateral or regional "free trade" outweigh the welfare losses due to "trade diversion" that reduces trade with non-liberalizing jurisdictions) are beyond the scope of this article. A classic work that explores trade diversion and trade creation is Jacob Viner, The customs union issue (1950). For a more recent review of the literature on trade creation versus trade diversion, *see, e.g.*, Theo S. Eicher, Christian Henn, and Chris Papageorgiou, Trade Creation and Trade Diversion Revisited: Accounting for Model Uncertainty and Natural Trading Partner Effects (IMF Working Paper No. 08/66, March 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1112208&http://www.google.com/search?hl=en&q=%22Trade+Creation+and+Trade+Diversion+Revisited%22+&aq=f&aqi=&aql=&oq=##.

2 We use the term "consumer welfare" as including the sum of consumers' and producers' surplus. This is consistent with the approach recommended by the legal scholar Robert Bork, see Robert H. Bork, The antitrust paradox 90-106 (rev. ed. 1993) (deeming the maximization of allocative and productive efficiency (which are associated with consumers' surplus and producers' surplus, respectively) to be the appropriate goal of U.S. antitrust enforcement). Consumer welfare-reducing restrictions could be either private (such as, for example, "naked" price fixing, division of markets among competitors, and other anticompetitive contracts) or public (such as, for example, onerous licensing requirements, other restrictions on entry into businesses or professions, and prohibitions on truthful advertising). Public restraints tend to be the most pernicious, because the normal market forces that tend to undermine private restraints (for instance, entry by new competitors) cannot undermine such restraints, which are backed by the force of law. Only changes to the law, which will be lobbied against by the beneficiaries of the anticompetitive status quo, can undo restraints imposed by government. For an overview of the growing international consensus regarding the harmful nature of government restraints on competition, see James C.Cooper and William E. Kovacic, *U.S. Convergence with International Competition Norms: Antitrust Law and Public Restraints on Competition*,"90 B. U. L. Rev. 1555 (2010), *available at* http://www.ftc.gov/speeches/kovacic/2010convergencecomment.pdf.

3 For a general discussion of these policies, *see*, *e.g.*, J. Michael Finger, Keith Hall, and Douglas R. Nelson, *The Political Economy of Administered Protection*, 72 American econ. Rev. 452 (1982); Richard H. Clarida, *Dumping in Theory, in Policy, and in Practice*, in Fair trade and harmonization (Jagdish Bhagwati and Robert Hudec eds., 1996); Howard Marvel and Edward Ray, *Countervailing Duties*, 105 ECON. J. 1576 (1995).

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global trade liberalization, import competition and thus economic growth[4]. Also, regional and bilateral trade liberalization compacts, such as the European Union (originally a "customs union" that was transformed into a vehicle for large scale European economic integration), the North American Free Trade Agreement ("NAFTA," covering the United States, Canada, and Mexico), and the U.S.-Korea Free Trade Agreement (one of several such agreements entered into by the United States), have been a force for enhancing welfare by extending the geographic extent and scope of trading and investment opportunities[5].

4. Nevertheless, there are limits to the welfare gains that can be achieved by trade liberalization. Political constraints have precluded WTO members from agreeing to full scale free trade, and have caused the retention of welfare-reducing import restraints such as antidumping and countervailing duty laws[6]. However, the WTO system is now attempting to deal with a number of these regulatory restrictions. Specifically, the WTO has embraced disciplines on anti-competitive private sector restraints (GATS Article IX), and specific anti-competitive restraints on a sectoral basis (Basic Telecom Agreement and Reference Paper on Competition safeguards). Furthermore, even the GATT 1947 contains provisions that are drawn from the competition lexicon (Article III 2 of GATT 1947, which prohibits discriminatory taxation interpreted by the cases to require "equality of competitive opportunity".) GATT Article XVII which limits the range of activities of State-Trading Enterprises (STEs). Under Article XVII, STEs are subject to commercial considerations when operating in commercial markets and "fair and equitable" standards when buying for themselves. Both of those standards are really competition standards. Indeed, in the leading case on Article XVII, the U.S. agreed that "commercial considerations" meant profit-maximizing behavior (in other words, any behavior that was not profit-maximizing was not "commercial"). Regrettably the language of trade negotiators has not caught up to this new reality. Trade negotiators still employ mercantilist terms in characterizing the dismantling of an import restraint as a "concession" for which a quid pro quo is required, rather than as an unalloyed consumer welfare benefit that may be expected to invigorate domestic competition – even where foreign countries may not reciprocate by lowering import barriers of their own.

5. But, this said, the WTO and other trade agreements simply do not reach a variety of welfare-reducing government measures that create de facto trade barriers by favoring domestic interests over foreign competitors. Moreover, many of these restraints are not in place to discriminate against foreign entities, but rather exist to promote certain favored firms. We dub these restrictions "anticompetitive market distortions" or "ACMDs," in that they involve government actions that empower certain private interests to obtain or retain artificial competitive advantages over their rivals be they foreign or domestic. ACMDs, unfortunately, are not readily reached by competition laws. Such laws typically focus primarily on private anticompetitive actions, or, when they restrain government actions, typically identify explicit sorts of government action that fall outside the "hybrid" nature of ACMDs.

6. This article assesses the nature of these ACMDs, and the poor history of government and international institutions in dealing with them. It briefly demonstrates that the WTO has not been able (and in the near term almost certainly will not be able) to cope adequately with these restraints. It then strikes a more hopeful note, however, by suggesting that there are a number of policy tools that could be used to deal with the ACMD problem. In addition to a global agreement on ACMDs, we also propose that the multilateral International Competition Network ("ICN") – and, in particular, the ICN's Advocacy Working Group – may be a possible near term vehicle for beginning to confront (or at least beginning to highlight) the harm of ACMDs. With that in mind, this article proposed the development of a metric to estimate the net welfare costs of ACMDs. Such a metric could help strengthen the hand of the ICN – and of reform-minded public officials – in building the case for the dismantling these restraints, or their replacement by less costly means for benefiting favored constituencies. Over time, it may be hoped that "soft convergence" under the aegis of the ICN may begin to lead some jurisdictions to chip away at, if not wholly dismantle, harmful ACMDs – or at least to begin to replace ACMDs with less harmful means of benefiting favored constituencies. To the extent this occurs, restrictions on welfare-enhancing international commerce will be further diminished and national competition policies may be expected to be deployed more effectively in the consumer (and public) interest. This will be especially true if there are other policy tools which give domestic competition agencies some external credibility within their own governments.

II. Nature of ACMDs

7. For purposes of our discussion, ACMDs include: (1) governmental restraints that distort markets and lessen competition; and (2) anticompetitive private arrangements that are backed by government actions, have substantial effects on trade outside the jurisdiction that imposes the restrictions, and are not readily susceptible to domestic competition law challenge. The most pernicious ACMDs are those that artificially alter the cost-base as between competing firms. Such cost changes will have large and immediate effects on market shares, and therefore on international trade flows.

8. With the growing internationalization of commerce, ACMDs not only diminish domestic consumer welfare – they increasingly may have a harmful effect on foreign enterprises that seek to do business in the country imposing the restraint. The home nations of the affected foreign enterprises, moreover, may as a practical matter find it not feasible to apply their competition laws extraterritorially to

4 The WTO has also established a binding trade dispute resolution framework for assessing complaints regarding the alleged illegal application of anti-dumping and countervailing standards, among other rules. This framework, albeit imperfect, has provided a means for somewhat constraining international "trade wars" and constraining the application of protectionist policies.

5 Such agreements diminish welfare, however, to the extent that they divert more trade away from the rest of the world than they create within the liberalized trade bloc. See note 1, *supra*.

6 Commendably, however, the WTO has constrained the burdensomeness of antidumping and countervailing duty rules by establishing limiting codes covering those restraints and by providing for binding dispute resolution of countervailing duty and dumping claims under those codes – as well as dispute resolution of other sorts of trade restraints.

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curb the restraint, given issues of jurisdictional reach and comity (particularly if the restraint flies under the colors of domestic law). Because ACMDs also have not been constrained by international trade liberalization initiatives, they pose a serious challenge to global welfare enhancement by curtailing potential trade and investment opportunities. We now turn to the efforts of the trading system thus far to come to grip with these types of restraints.

III. The WTO and ACMDs

9. The WTO has only a limited ability to combat ACMDs. Most such restraints either fall outside the strictures found in the various WTO Codes and Agreements, or, even if they do not, the WTO has proven itself largely unable to tackle them or to apply the right metric to analyze them[7]. The three notable examples of efforts to reach ACMDs through WTO enforcement actions deserve brief scrutiny, for they illustrate not only the limitations inherent in the current WTO framework, but also the direction of WTO policy.

10. *Kodak/Fuji Film.* Kodak claimed that it was seriously handicapped in its efforts to enter the Japanese film market by a combination of Japanese government and private restraints that, cumulatively, blocked efficient entry into the Japanese film market by foreign firms. The WTO Appellate Body in 1998 found that the restraint in question – involving practices that included government-supported restrictions on film distribution channels – did not implicate violations of Japan's WTO trade commitments[8].

11. *Mexican Telecoms*[9]. COFETEL, Mexico's telecommunications regulatory agency, conferred on Telmex, the dominant Mexican telecommunications company (initially state-owned and then privatized), the power to fix the rate to be paid to all foreign telecommunications carriers terminating calls in Mexico. COFETEL rules, which mandated that those companies charge no less than the Telmex fee for termination, decreed a market-sharing system in support of the high price. The United States filed a claim with the WTO, arguing that these cartel-like incumbent protection regulatory arrangements violated Mexico's WTO commitments to open up its telecommunications market. The panel in large part ruled in favor of the United States, finding that Mexico had failed to ensure interconnection at cost-oriented rates; had failed to prevent anticompetitive practices by a major telecommunications supplier (Telmex); and had failed to ensure reasonable and non-discriminatory access to and use of telecommunications networks. In 2005, Mexico announced that it had fully complied with the panel's recommendations by promulgating new resale regulations allowing for the commercial resale of long distance and international long distance services originating in Mexico, and the United States expressed satisfaction with these changes.

12. *Canada Wheat Board*[10]. This case concerned the role of an STE, the Canada Wheat Board (CWB) in the purchase and sale of wheat on international markets. The U.S. challenged the CWB's practices as violating GATT Article XVII. The U.S. contended that Canada and the CWB must afford competing wheat sellers as well as potential wheat buyers an "adequate opportunity… to compete for participation in [the CWB's] sales." The U.S. argued that the CWB had to act like a commercial seller, and that it could not use its special privileges to the disadvantage of other commercial actors. The U.S. charged that because the CWB Act was a mandate to promote sales, rather than profits this necessarily led CWB to take unfair advantage of its privileges. The Panel took a very narrow view of "commercial considerations", noting that this merely required STEs not to act like "political actors". It thus rejected the U.S.'s thesis that the structure of the CWB necessarily resulted in sales inconsistent with Article XVII.

IV. Measuring the welfare effects of ACMDs

13. In order to better assess and compare individual ACMDs – and to build the case for phasing out or dismantling them – a metric should be devised to produce estimates of the welfare effects of particular restrictions. Below we briefly sketch a proposal for developing such a metric. Although any metric is bound to be imprecise in application, it should be possible to produce "rough and ready" estimates of the social costs of ACMDs through this exercise. The metric, which could be refined in light of economic learning and case studies, might help inspire a broader international dialogue on welfare-reducing government measures.

V. A metric for measuring ACMDs

14. The question is what is the best metric for measuring ACMDs? Historically, analysis of behind the border trade barriers, or regulatory protection has focused on the impact of these barriers on trade flows. However, we suggest that this metric does not properly evaluate the true impact of ACMDs. While it clearly measures the impact of the barrier on external trade, it does not properly measure the true impact of the ACMD under scrutiny on the domestic economy in the country where the ACMD exists. A better measure of this

7 One of the authors has advocated creation of a multilateral public sector restraints agreement, building on existing WTO jurisprudence and introducing more centrally concepts of consumer welfare enhancement into the discussions of trade restricting government measures. See Shanker Singham, A general theory of trade and competition: trade liberalization and competitive markets 429-441 (2007). Although the authors strongly support such an approach, political constraints may preclude its adoption (or even serious consideration) in the near future. The more modest short-term approach advocated in this article, which emphasizes reliance on non-binding advocacy, is fully consistent with the more ambitious long-term goal of establishing a binding international agreement; the two approaches are complements, not substitutes.

8 Panel Report, *Japan – Measures Affecting Consumer Photographic Film and Paper*, WT/DS44/R (Mar. 31, 1998) (adopted Apr. 22, 1998).

9 See Panel Report, Mexico – Measures Affecting Telecommunications Services, WT/DS204/R (Apr. 2, 2004) (adopted June 1, 2004), ¶¶ 7.222-.224. The discussion of the *Mexican Telecoms* matter is based on Eleanor Fox and Daniel Crane, Global issues in antitrust and competition law 413-417 (2910); and on World Trade Organization, Dispute Settlement: Dispute DS-204 (Mexico – Measures Affecting Telecommunications Services) (current status as of Feb. 24, 2010), *available at* http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds204_e.htm.

10 The following discussion of this case draws upon SHANKER SINGHAM, *supra note* 9, at 203-218.

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is a welfare-based metric based on the implications of the measure for consumer welfare (as previously defined). The type of analysis would be a standard partial equilibrium analysis[11] where the ACMD itself would act as an external shock and the reduction in consumer welfare occasioned by this shock would be measured. The estimate would not need to be exact – it could be stated as a rough estimate, plus or minus a certain percentage (error tolerance). Such an approach could add credibility by recognizing imperfections in estimation and limitations on knowledge, while at the same time highlighting the real harm to domestic interests flowing from the ACMD. More generally, by highlighting the aggregate deleterious effects of ACMDs on the domestic public at large, broad adoption of this metric might marginally weaken *ex ante* private and public incentives to adopt new ACMDs in the first place.

VI. The ICN and ACMDs

15. Although *ACMDs* may not readily be reached by direct antitrust enforcement (as yet), law or formal WTO trade enforcement mechanisms, they nevertheless may be susceptible to being undermined through targeted "competition advocacy" initiatives. These initiatives would stand separate from, but would be supported by, other policy tools including a global agreement as well as regulatory dialogues. Central to the solution of the ACMD problem are competition advocacy interventions by domestic competition agencies. Such competition advocacy initiatives involve efforts by competition agencies to ensure that competition considerations are weighed in the formulation of laws, regulations, and public policies. Often competition advocacy may involve critiques of draft rules or laws on the grounds that the proposed formulations would block or distort consumers and thereby reduce consumer welfare. In recent years, in discussions with emerging competition regimes, major competition agencies (such as the U.S. Federal Trade Commission, the U.S. Department of Justice, and the European Commission's Directorate General for Competition) have promoted competition advocacy as a valuable method for consumer welfare enhancement[12].

16. Consistent with this recent trend, the international "virtual network" dedicated to competition policy, the ICN, established an Advocacy Working Group ("Advocacy Group") in 2001[13]. The initial efforts of the Advocacy Group centered on the identification of advocacy "best practices" and the provision of information to ICN members in support of their advocacy activities. In 2008, the Advocacy Group redirected its efforts to the carrying out of case-specific "market studies," with the goal of identifying good practices for conducting studies. During 2009-2010, the Group conducted five teleseminars in which ICN member agencies described their experiences in advocating competition. The teleseminars focused on building relationships between a competition authority and the private bar; government involvement in markets; the role of international organizations in advocacy; competition in the financial markets; and evaluation of particular agencies' competition advocacy programs. The Advocacy Group promoted an advocacy best practices handbook and Competition Advocacy "Toolkit" in 2010-2011, with the aim of spreading the "culture" of advocacy studies. It also has established an ICN data bank of advocacy studies ("Market Studies Information Store"). The Advocacy Group also liaises with the ICN's "Advocacy and Implementation Network" in order to generate advocacy recommendations for new competition regimes ("beneficiary agencies").

17. The Advocacy Group is ideally suited to promote the study and, hopefully, the gradual elimination of, ACMDs that harm consumer welfare. As part of a consensus-building international body, the Advocacy Group can shed a spotlight on a regime's regulatory practices that reduce consumer welfare, without the coercive aspect associated with litigation or state-to-state negotiations[14]. Application of a well-regarded metric for measuring the effects of particular ACMDs could strengthen the hands of national competition officials – invoking the imprimatur of the ICN – in arguing for welfare-enhancing reforms.

11 A partial equilibrium analysis "analyzes the behavior of a single market, household, or firm, taking the behavior of all other markets and the rest of the economy as given." Paul A. Samuelson & William D. Nordhaus, Economics 287 (14th ed. 1992). We do not consider the possibility, suggested by the "theory of the second best," that the welfare harm in the market primarily affected by the ACMD would be more than offset by welfare gains elsewhere, due to the interaction among markets. Leading antitrust commentators have consistently upheld partial equilibrium approaches as key to the carrying out of competition policy, and have dismissed second best concerns, based on the real world impossibility of analyzing all potential interactions among markets and on the high likelihood that market-specific partial equilibrium competition analyses "get it right." *See, e.g.*, Robert H. Bork, *supra* note 2, at 113-114; Richard A. Posner, Antitrust Law 13 n.5 (2nd ed. 2001).

12 For a good overview of the importance of competition advocacy as a tool to combat government-sponsored restraints on competition, see James C. Cooper and William E. Kovacic, note 2 *supra*.

13 The ICN was established in 2001 as an international "virtual network" for the promotion of "soft convergence" among competition policy regimes through the exchange of information among competition agencies and expert "non-governmental advisors." The ICN states that it "provides competition authorities with a specialized yet informal venue for maintaining regular contacts and addressing practical competition concerns. This allows for a dynamic dialogue that serves to build consensus and convergence towards sound competition policy principles across the global antitrust community. The ICN is unique as it is the only international body devoted exclusively to competition law enforcement and its members represent national and multinational competition authorities. Members produce work products through their involvement in flexible project-oriented and results-based working groups. Working group members work together largely by Internet, telephone, teleseminars and webinars." http://www.internationalcompetitionnetwork.org/about.aspx. Information on the ICN's Advocacy Working Group is available at http://www.internationalcompetitionnetwork.org/working-groups/current/advocacy.aspx. The following main textual discussion is drawn from this web entry.

14 Interjecting the ICN into critiques of anticompetitive government practices is not without precedent – the ICN already has adopted consensus materials that can be applied to advocate against abuses of state-sponsored market power. In particular, the ICN has adopted a document drafted by the ICN's Unilateral Conduct Working Group entitled "State Created Monopolies Analysis Pursuant to Unilateral Conduct Laws – Recommended Practices" ("RP"), *available at* http://www.internationalcompetitionnetwork.org/uploads/library/doc318.pdf. The RP include giving competition authorities "an effective role" for promoting competition in connection with privatization and market liberalization efforts. The RP also endorse bestowing on competition authorities "effective competition advocacy instruments," including providing "expert reports" and "recommendations" to government bodies responsible for liberalization/privatization; participation in meetings and briefings with key government officials; an ability to bring legislative and administrative actions before the courts; and publication of competition authority opinions in order to spark public debate. Aggressive ICN efforts to advance the role of domestic competition agencies in taking on international hybrid restraints would be very much in keeping with the tradition embodied in the State Created Monopolies RP.

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18. The Advocacy Group could perhaps further advance competition advocacy efforts by publicizing economic techniques that may be used to estimate the magnitude of welfare losses associated with particular restraints. Estimates derived from specific case studies that highlight the extent of foregone welfare due to lack of competition may spur efforts to "phase out" *ACMDs* in favor of less socially costly support for favored constituencies, such as direct targeted subsidies. Eventually, well-supported empirical welfare loss estimates might build the case for avoiding less costly "substitute" policies altogether, and lead to the actual elimination of *ACMDs*. In particular, the ICN's Advocacy Working Group might formulate some additional general principles from such studies, which could be included in its Competition Advocacy Toolkit – and publicized by the ICN as a whole.

VII. Conclusion

19. Interest group politics and associated rent-seeking by well-organized private actors are endemic to modern economic life, guaranteeing that *ACMDs* (not to mention many other sorts of restrictions that are directly shielded by state action immunity) will not easily be rooted out. Nevertheless, the ICN's Advocacy Working Group may provide a good vehicle to assist competition agencies worldwide in their efforts to highlight the baleful effects of such restraints. While this proposed solution is not the only pathway that must be followed, the Advocacy Working Group may provide the tools that, over time, convince state actors to phase out or eliminate particularly egregious restraints. To the extent this occurs, consumer welfare will benefit, and trade and competition policy will prove more effective in promoting a welfare-enhancing economic growth agenda. ■

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