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A Response to the Effectiveness of Proposed Antitrust Programs for Developing Countries

Cover Page Footnote

International Law; Commercial Law; Law

A Response to "The Effectiveness of Proposed Antitrust Programs for Developing Countries"

Craig W. Conrath† and Barry T. Freeman††

Is it a good idea or a bad idea for former communist countries, or other economies in transition to market economies, to adopt antitrust laws? A fierce debate over this question has raged among American antitrust economists and lawyers.¹ In Central and Eastern Europe, however, this question has hardly made a ripple²—it was quickly answered in the affirmative.³ Yet, in the United States the debate continues.⁴ The latest contribution to this debate is from A.E. Rodriguez and Mark D. Williams.⁵ We believe that a careful analysis of their arguments against antitrust enforcement may help explain why their side of the debate has not received much acceptance in Central and Eastern Europe or other economies in transition.

The value of antitrust enforcement has been questioned by some who suggest that free trade alone will prevent the accumulation of

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¹ See Roger Boner & James Langenfeld, *Liberal Trade and Antitrust in Developing Nations*, REG., Spring 1992, at 5; Paul E. Godek, *One U.S. Export Eastern Europe Doesn't Need*, REG., Winter 1992, at 21; Paul E. Godek, *Protecting Eastern Europe from Antitrust*, REG., Fall 1992, at 4; James Langenfeld & Marsha W. Blitzer, *Is Competition Policy the Last Thing Central and Eastern Europe Need?* 6 AM. U. J. INT'L L. & POL'Y 347 (1991); Janusz A. Ordover & Russell W. Pittman, *The Role of Antitrust in Eastern Europe*, REG., Summer 1992, at 5.

² For example, in Poland, the 1990 Antimonopoly Law passed the Sejm (the lower house of the Polish parliament) by a vote of 197-21 (with 31 abstentions). The 1991 amendments strengthening that law passed by 211-35 (with 18 abstentions).

³ From 1990 to late 1993, new antimonopoly laws were adopted in Poland, Czechoslovakia (now in force in both the Czech Republic and Slovakia), Hungary, Bulgaria, Latvia, Lithuania, Estonia, Russia, Ukraine, Belarus, and Kazakhstan. No former communist state or new state, to our knowledge, has voted down a proposed antimonopoly law. Of particular interest to the United States, Mexico has also enacted a new competition law.

⁴ This intriguing dichotomy may reveal more about American antitrust economists and lawyers than about Central and Eastern European policy makers, but that is a question for another article.

⁵ A.E. Rodriguez & Mark D. Williams, *The Effectiveness of Proposed Antitrust Programs for Developing Countries*, 19 N.C. J. INT'L L. & COM. REC. 209 (1993).

market power.⁶ Previous observations of trade liberalization policies, however, have not seen the expected increase in competition⁷ as firms most affected by tariff reductions lobby the government to impose non-tariff barriers in order to continue to protect their markets from competition; in other words, these firms engage in “rent-seeking” (attempting to obtain monopoly profits). Thus, non-tariff barriers replace tariffs in protecting domestic competitors. According to Rodriguez and Williams, the characteristics of the polity of the typical developing or post-communist country mean that it is relatively easy for domestic industries to obtain such government-mandated protection from competition.⁸

Rodriguez and Williams view the imposition of non-tariff barriers as an alternative (or substitute) to cartelization as a means for firms to protect themselves from competition. Antitrust enforcement, by raising the cost of cartelization, according to Rodriguez and Williams, increases the amount of rent-seeking by affected groups. Thus, Rodriguez and Williams claim, even if antitrust enforcement is successful in raising the cost of cartelization, this success does not benefit consumers because the affected firms will simply shift to rent-seeking in the form of lobbying for non-tariff barriers. Competition agencies, the authors allege, cannot prevent or limit such barriers through competition advocacy programs. Such programs, they argue, face large political and bureaucratic hurdles. The implication of their analysis is that antitrust laws and antitrust enforcement are wasteful because they are not likely to increase competition (or reduce monopoly) in these economies in transition.⁹

There are two main flaws in Rodriguez and Williams’s analysis. First, they make a fundamental analytical error by assuming that cartelization and trade barriers are substitutes for one another. In fact, they are better viewed as complements; if firms have one, they still have good reasons to desire the other.¹⁰ Second, Rodriguez and Williams are overly pessimistic about competition advocacy as a tool for limiting the harm to consumers caused by government over-regulation. Competition advocacy is not a perfect tool, but it can be useful.

In this paper, we first describe the phenomena of cartelization

⁶ See Godek, *One U.S. Export Eastern Europe Doesn't Need*, *supra* note 1.

⁷ Rodriguez & Williams, *supra* note 5, at 210 n.3.

⁸ *Id.* at 219.

⁹ Rodriguez and Williams do not offer any alternative as to how competition should be created in these countries.

¹⁰ We use the terms complements and substitutes in a production setting rather than a consumption setting. Hence, cartelization and trade barriers are complementary inputs into the production of supracompetitive profits in the same manner that sunlight and rainfall are complementary inputs for the production of crops. The marginal output from a given amount of one of the inputs is increased when some of the other is used concurrently. Rodriguez and Williams view cartelization and trade barriers predominantly as alternative inputs for obtaining supracompetitive profits.

and import restrictions separately. Then we examine how they interact and explain how this interaction demonstrates that they are better viewed not as substitutes, but as complements. Subsequently, we briefly comment on Rodriguez and Williams's critique of "competition advocacy" programs.

I. Cartelization and Import Restrictions Are More Like Complements than Substitutes

Rodriguez and Williams treat cartelization and import restrictions as substitutes. They view the two as alternative sources of supracompetitive profits. A more careful analysis, however, shows the limitations of this view. We begin by examining the profitability of trade restrictions and of cartelization.

As economic phenomena, a trade barrier is a shift of a supply curve, while cartelization is a movement along a supply curve. A domestic industry is always better off if it can do both, rather than just one or the other.¹¹ In other words, if a domestic industry has trade barriers, it can improve its profits by cartelizing. If a domestic industry has a cartel, it can improve its position by obtaining trade barriers. Let us examine why this is true.

A. Five Illustrative Cases

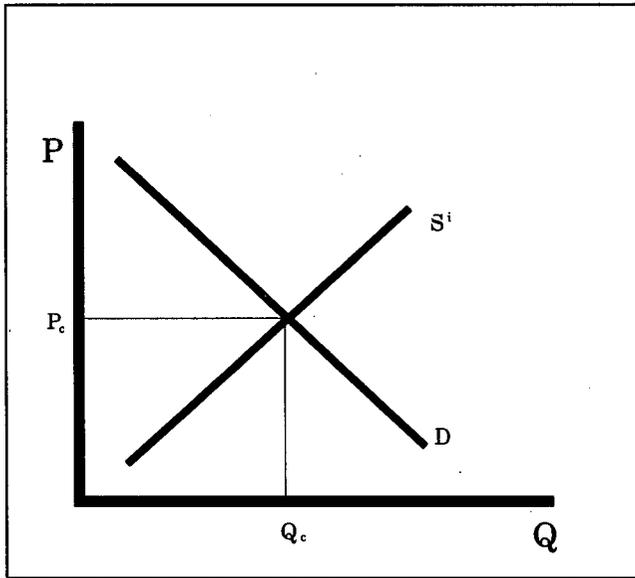
Consider an economy in transition, with relatively inefficient local production. The product is produced both domestically and abroad. Foreign producers have lower production costs.

Case 1: Open Competitive Market

Figure 1 shows the demand (D) curve for this industry. The demand curve is downward sloping to reflect the fact that decreases in price cause the quantity demanded to increase (if all else is equal). Supply from both domestic producers and imports is referred to here as international supply. The international industry supply curve, S^i , shows the total quantity that would be supplied at a given price. This is also shown in Figure 1.

¹¹ This assumes that the demand curve and supply curve have their normal slopes, i.e., are negatively and positively sloped, respectively.

Figure 1
Open Competitive Market
(No Import Restrictions, No Cartel)



In this fully competitive and open market, the competitive (equilibrium) price and quantity, shown as P_c and Q_c , are determined where the supply and demand curves intersect. Consumers are purchasing the product at the lowest possible price. At this competitive price, some (or all) domestic producers may face losses, and they must either make dramatic productivity improvements (that is, adopt a competitive response) or go out of business.¹² Suppose instead that these domestic producers try something other than a competitive response; they may attempt to cartelize or to obtain rents through government trade restrictions.¹³ We examine the effect of these non-competitive responses, first individually and then together, on prices and output in the industry.

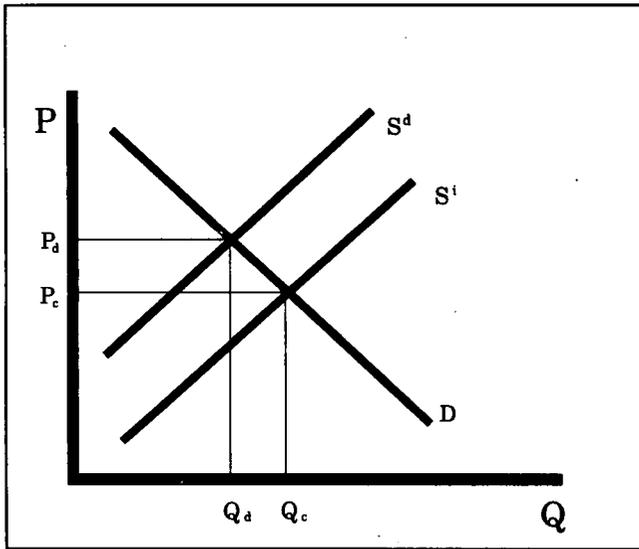
¹² If all firms in the industry, both foreign and domestic, had identical cost curves, then no abnormal profits would be earned by the producers. Different cost structures would not alter the results. In such a situation, the marginal supplier would earn zero abnormal profits while other producers would earn abnormal returns because of their efficient production.

¹³ In order to isolate the effects of these phenomena, we will consider the hypothetical cases in which a perfect cartel could be organized or in which completely effective import restrictions could be imposed. We also do not consider the costs of implementing these solutions. The basic operation of these phenomena does not change with typical realistic changes to these conditions. See *infra* note 21 (discussing some of the implications of such relaxations).

Case 2: Closed Uncartelized Market

We will now consider what happens if the domestic industry obtains import restrictions. What is the effect of trade barriers on domestic producers, without cartelization?

Figure 2
Closed Uncartelized Market
(Import Restrictions, but No Cartel)

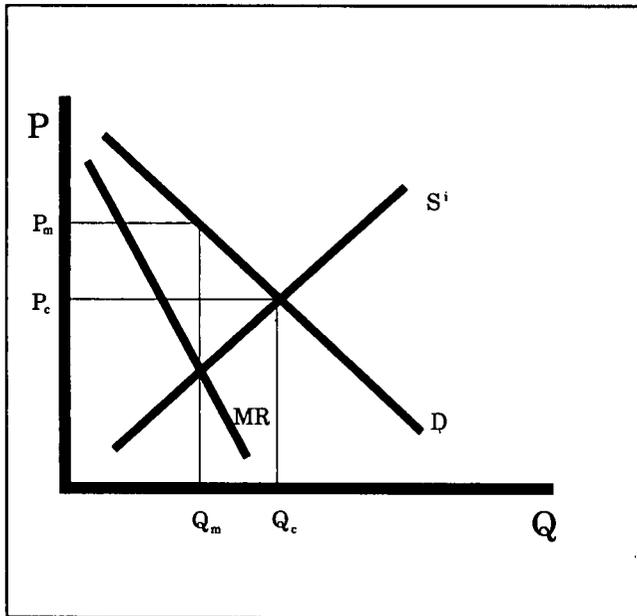


In Figure 2, the supply curve now encompasses only domestic supply, and is designated S^d . It has shifted to the left relative to S^i . As a result, less of the product will be supplied at any price. The equilibrium price increases from P_c to P_d , while quantity supplied decreases from Q_c to Q_d . Hence, consumers are worse off. By contrast, domestic producers are better off. They do not face low cost competition from imports and thus can avoid difficult, even wrenching, decisions about productivity improvements.

Case 3: Open Cartelized Market

Instead of obtaining import restrictions, assume the industry organizes a cartel. In this case, of course, the domestic producers would be forced to convince their foreign competitors to participate in a cartel. Depending upon a variety of factors, this could or could not be difficult. But if the industry does cartelize, then the results can be seen by examining Figure 3.

Figure 3
Open Cartelized Market
(Cartel, but No Import Restrictions)



The members of the industry join a cartel that agrees to restrict output. The cartel, acting as a collusive monopoly, will maximize its profits by producing the quantity which equates the marginal revenue (the additional industry revenue generated by selling one more unit of output) and the marginal cost (the additional cost of producing that unit of output).¹⁴ As a result of cartelization, the price increases to the monopoly price, P_m , and quantity decreases to Q_m . Consumers are worse off than in the competitive open market case. Society suffers a deadweight loss in the form of inefficient allocation of resources.¹⁵ Supracompetitive profits are earned by the producers in the industry, as a whole. Domestic producers who are less efficient than the foreign producers may not earn monopoly profits, but merely earn normal profits (or smaller losses). Nonetheless, these relatively inefficient pro-

¹⁴ In this case, the marginal cost curve can be represented by the industry supply curve, S' . The marginal revenue curve, shown as MR, reveals that, in order for the cartel to sell an additional unit of output, price must be lowered for all output that the collusive monopoly sells, i.e., the cartel is a price maker. The point where the marginal revenue and marginal cost curves intersect indicates the quantity that is produced by the cartel; the demand curve determines the price that will be charged for this quantity (the monopoly price).

¹⁵ See DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 104 (1990). Cf. RICHARD A. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 11-14 (1976) (rent-seeking, as well as deadweight loss, must be considered among societal costs of monopoly).

ducers are better off than they would be without the cartel. Foreign producers earn monopoly profits but must forego unlimited expansion into the market.¹⁶

Note that both import restrictions and cartelization lead to supracompetitive profits. It is not clear, however, which would be preferred by the industry if they were forced to choose one or the other. This choice would depend on several factors, including the elasticity of demand, costs of production by domestic and foreign producers, and the relative market share of imports.

We have described the competitive open market, the market with import restrictions, and the market with a cartel. The next step is to complicate the matter further. If import restrictions and cartelization were really substitutes as Rodriguez and Williams imply,¹⁷ the effect of adding cartelization to a market with import restrictions (or vice versa) would be negligible.

Case 4: Closed Market That Is Cartelized

Imagine that import restrictions exist. Will it be in the interest of domestic producers to form a cartel? If Rodriguez and Williams are correct in suggesting that import restrictions and cartelization are substitutes, one would expect that the domestic producers would be indifferent to forming a cartel. As they said, "Often, the gains to interest groups of establishing cartels or price-fixing schemes are outweighed by simply soliciting preferential treatment from the state. If *potential monopolists are uninterested in cartelizing*, then the role of antitrust is slight."¹⁸

As shown in Figure 4, however, the domestic industry normally *will* be interested in cartelizing. Figure 4 shows the original international supply curve, S^i , and the domestic supply curve, S^d , that exist after import restrictions have been imposed. In short, the imposition of import restrictions has shifted the supply curve to the left. Price and quantity are P_d and Q_d .

Suppose the members of the domestic industry now form a cartel which agrees to restrict output. The cartel, acting as a collusive monopoly, maximizes its profits by producing the quantity which equates marginal revenue and marginal cost.¹⁹ As a result of cartelization, the price increases to the domestic monopoly price, P_{dm} , and quantity decreases to Q_{dm} .²⁰ Consumers are even worse off than in the competitive closed market. Prices are higher; P_{dm} will always be greater than

¹⁶ The foreign producers may or may not be willing to do this. This is a matter of negotiating among domestic and foreign producers. It is simply one variation of the typical problem of cartels to decide how to divide up the monopoly rents.

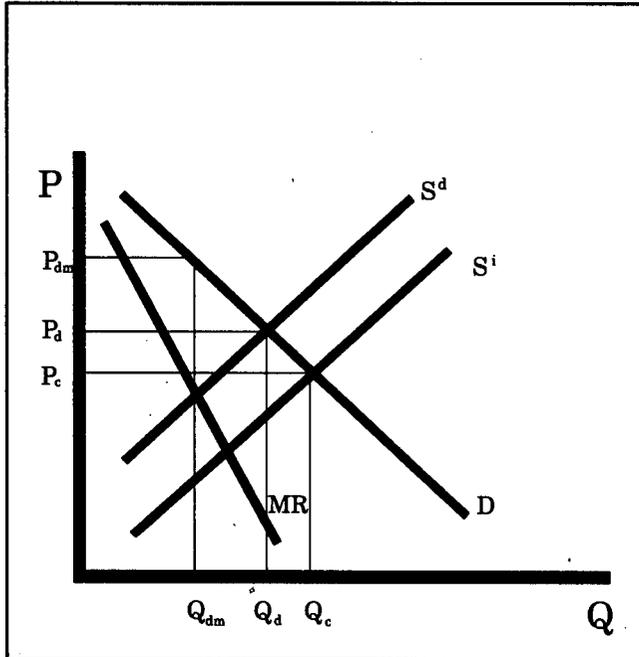
¹⁷ Rodriguez & Williams, *supra* note 5, at 224-25 (indifference curves imply substitutes).

¹⁸ *Id.* at 231 (emphasis added).

¹⁹ The marginal cost curve, represented by the industry supply curve, is now S^d .

²⁰ The monopolist sells the output Q_m at the price represented by the demand curve.

Figure 4
Closed Market That Is Cartelized
(Import Restrictions and Cartel;
Closed Market That Is Subsequently Cartelized)

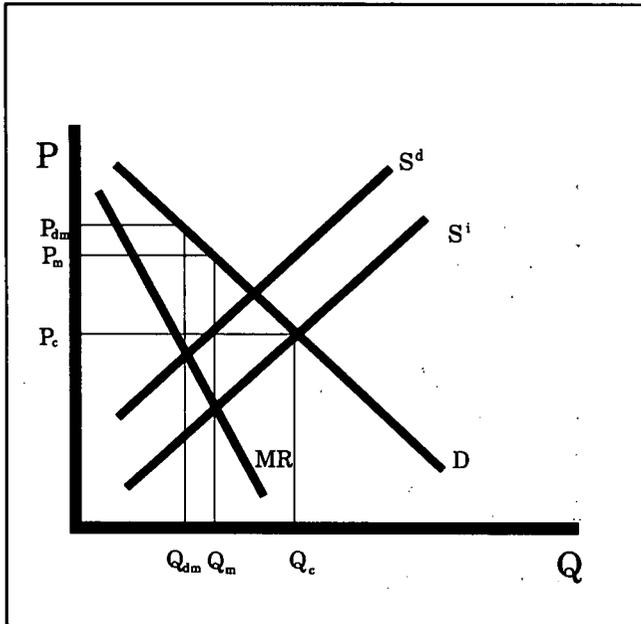


P_d . Output is lower. Supracompetitive profits are earned by the domestic producers, even above those earned in the competitive (uncartelized) but import restricted market. Therefore, the domestic industry has the incentive to cartelize even when import restrictions exist.

Case 5: Cartelized Market That Is Closed

A similar comparison can be made by beginning with the open, but cartelized market. The domestic producers, already part of a cartel, would benefit from the establishment of import restrictions that prevent foreign competitors from selling in the country.

Figure 5
Cartelized Market That Is Closed
(Import Restrictions and Cartel;
Cartelized Market That is Subsequently Closed)



In Figure 5, the cartelized industry is producing Q_m , the collusive monopoly quantity on the international supply curve S^i . When imports are restricted, the new supply curve is S^d . Because the cartel is still in place—albeit with only domestic producers—the participants now maximize profits by producing where MR intersects S^d (the new marginal cost curve). The monopoly quantity now produced, Q_{dm} , is less than Q_m . Price increases from P_m to P_{dm} . Consumers are worse off than they were before the import restrictions were imposed, while the domestic industry is better off.

Let us summarize the preceding analysis.²¹ If an industry has im-

²¹ For the sake of clarity, the foregoing discussion did not consider the effect of the costs of organizing a cartel or of obtaining import restrictions. In short, our model has assumed that import restrictions and cartelization can occur costlessly. This assumption implies that import restrictions eliminate all foreign producers and that cartels can prevent cheating. In reality, of course, this is not the case. Introducing transaction costs, however, means that the industry is only likely to be partially successful in achieving these goals. Thus, consideration of these cost factors does not change our results.

However, when costs are introduced, the firms must choose the amount of resources to devote to these activities. Rodriguez and Williams view the problem with budget constraints and isocost curves. Rodriguez & Williams, *supra* note 5, at 224. They show that when resources are devoted to either forming a cartel or lobbying for import restrictions, an increase in the cost of one of these activities results in a shift of resources to the other. This approach

port restrictions, it can increase its profits by cartelizing. Alternatively, if an industry is cartelized, it can increase its profits by obtaining import restrictions. An industry which successfully cartelizes *and* obtains import restrictions earns greater supracompetitive profits than an industry that does only one or the other.

Although cartelization and trade restrictions both have the effect of increasing prices to consumers, they do so by alternative means. Cartelization decreases quantity on a given supply curve, while import restrictions shift the supply curve inward. Rodriguez and Williams argue that efforts at either method are substitutable to the interest group. Instead, as we have shown, the two methods are complementary.²² Therefore, the separate effects of cartelization, which Rodriguez and Williams doubt, are in fact a real threat. Thus, Rodriguez and Williams's conclusion—that preventing cartelization is not significant—is flawed. Rather, there can be benefits from preventing cartelization. Increasing the cost of cartelization forces firms in the industry to shift their time, effort, and resources towards other responses to competition. At worst, it will shift them towards obtaining additional import restrictions, a second-best solution for the industry. An industry that cannot cartelize but can only restrict imports will charge lower prices and earn fewer profits than an industry that can do both.

B. *Casual Empiricism*

Alternatively, it may be instructive to test Rodriguez and Williams's propositions with casual empiricism. If government protection from competition is so cheap and easy to obtain, and if it is a substitute for cartelization, we should not observe attempted cartelization or monopolization behavior in the economies in question. Cartel detection methods in Central Europe are not as advanced as they are in the United States, but there is nonetheless some evidence of cartelization in Central Europe. For example, Polish insurance companies, which do not face competition from abroad, nevertheless agreed on rates. Polish sugar companies agreed on prices.²³ Similarly, some Warsaw

is obviously true, but overly simplistic. A firm's opportunity for earning greater profits is not limited to these two alternatives. The firm can also increase profits by lowering costs, improving productive capacity or engaging in research and development. With limited resources, it must choose how to allocate these resources to best maximize overall profits. To maximize profits, the firm will devote resources to all of these activities until the additional profit per unit of marginal cost for each activity is equal. An increase in the cost of cartelization lowers the expected profitability from this activity and consequently causes the firm to shift away from cartelization into other profitable activities such as increased lobbying or cost-cutting efforts or other pro-competitive responses. However, it is entirely possible that the firm may choose not to increase its lobbying activities following an increase in the cost of cartelization.

²² Efforts to cartelize depend on whether competitive threats from imports are credible. For example, if domestic industry producers collude to restrict output, their efforts are hindered to the extent that imports can provide lower priced products to the market.

²³ *Przedsiębiorstwo Państwowe Cukrownie "Janikowo" v. Urząd Antymonopolowy [Janikowo Sugar Enterprise v. Antimonopoly Office]*, XVII A.M.R. 37/92 (1993).

taxicabs formed “groups” that agreed on supracompetitive fares²⁴ and chased away lower priced competitors from desirable taxi stands.²⁵ Why were these competitors trying to cartelize if, as Rodriguez and Williams claim, they simply could have obtained equivalent governmental protection from competition? The answer is not clear.²⁶ But it is clear that Rodriguez and Williams’s theory fails on this account.

Another casually empirical test may be made in more developed market economies. If trade restrictions make domestic competitors “uninterested in cartelizing,” then one should not often observe cartel behavior in import-restricted industries. Some well-known examples that suggest otherwise are the Japanese construction industry²⁷ and the European steel industry.²⁸ Indeed, the conventional wisdom is that the existence of import restrictions makes cartelization more likely, rather than less likely.²⁹

In short, cartelization is a problem whether or not there are import restrictions. In particular cases, it may be a larger or smaller problem than import restrictions. Whether large or small, it is a problem that can harm consumers, and such problems deserve solutions, if solutions are available. And cartelization is a problem that can be kept in check, if not solved. The cost of a reasonable deterrence program need not be high. Thus, antimonopoly agencies should attempt to prevent cartelization.

II. Competition Advocacy—Is It Really Hopeless?

As noted above, import restrictions are a problem that can cause serious harm to consumers. This is true whether or not there is cartelization. Can antimonopoly agencies do something about the serious problem of government protection from competition? Rodriguez and Williams examine the role of a “competition advocate” and find it limited. They note that administrative procedures may not provide for such advocacy³⁰ and that there are political and bureaucratic limitations.³¹ They also note the “unenforceability” of a competition advo-

²⁴ These fares were to 150% higher than the competitive fare, at one point.

²⁵ Personal experience of authors.

²⁶ Several explanations are possible: (1) bureaucracies may not be efficient at implementing interest groups’ goals; (2) some bureaucrats may be well-motivated rather than ill-motivated, i.e., they intend to do the right thing; (3) bureaucracies may be driven by inertia as much as by interest groups; and (4) bureaucracies may have to contend with opposing interest groups.

²⁷ *Compare Walled Up*, *ECONOMIST*, Oct. 30, 1993, at 76 (import barriers), with *NEC Unit Pays U.S. \$34 Million to Settle Bid-Rigging Charges*, *FTC WATCH*, May 20, 1991, at 10 (bid rigging).

²⁸ See W. GOLDBERG, AILING STEEL: *THE TRANSOCEANIC QUARREL* 111-22 (1986).

²⁹ See generally RICHARD A. POSNER & FRANK EASTERBROOK, *ANTITRUST CASES, ECONOMIC NOTES, AND OTHER MATERIALS* ch. 2 (2d ed. 1981).

³⁰ Rodriguez & Williams, *supra* note 5, at 230.

³¹ *Id.*

cate's views.³² Their only concrete suggestion for dealing with these problems is to define the antitrust agency's competition advocacy role in the country's constitution,³³ but ultimately they are thoroughly pessimistic.³⁴ They "doubt that any nation, developing or not, has the willingness or commitment necessary for such a controversial initiative."³⁵

The sad fact is that the world of policy formation is not a perfect place. If one's standard of success for competition advocates is whether they win all their battles, they will always be adjudged unsuccessful. A more realistic measure should be whether they are able to pick the most important fights and to make slow progress. As articulated by Anna Fornalczyk, the President of the Polish Antimonopoly Office, a competition agency must fight within the government to minimize import protection, recognizing that elimination of such protection is probably not a realistic goal:

At the Antimonopoly Office, we have fought against protectionism for over two years, and I am convinced that we must do away with protectionism if our industries are to grow strong enough to compete in the world market. Given the current state of Poland's economy, however, we have to temper our belief in free trade with a recognition of the economic and social arguments for setting tariff and non-tariff barriers. Thus, we have reserved our strongest objections to proposals for adopting trade barriers that are not tied to a specific, time-limited program to restructure the industry and then leave it to face competition in the world market.³⁶

Even if a competition agency has no formal powers over anticompetitive regulation—what Rodriguez and Williams refer to as "undeveloped or unknown" administrative procedures and "unenforceability" of agency views—competition advocacy can be effective. On one occasion, for example, the Polish agricultural ministry proposed a vast set of "equalizing tariffs" for food products that would have raised the

³² *Id.* at 223. "[A]dvocacy programs have generally lacked enforcement powers."

³³ *Id.* at 230.

³⁴ *Id.* at 231 "We are not encouraged by past attempts at competition advocacy by government agencies."

³⁵ *Id.* at 232.

³⁶ Anna Fornalczyk, Competition Policy During Transformation of a Centrally Planned Economy, in INTERNATIONAL ANTITRUST LAW AND POLICY: ANNUAL PROCEEDINGS OF THE FORDHAM CORPORATE LAW INSTITUTE 392-93 (Barry Hawk, ed., 1993). She offered a broader explanation of the role of a competition advocate on another occasion:

Following our responsibilities, the Antimonopoly Office has insisted on an expansion of market forces in the economy. Very often other ministries have treated us like a troublemaker. . . . For two years the Polish government has begun many restructuring programmes for various fields of the economy. These sectoral studies have been focused on the technical and economic aspects of firms' activities. First of all, these studies have been prepared to support the goals of the firms' management and employees. The majority of these programmes has not taken the interests of competition, consumers and society as a whole into account. . . . As you know very well, nobody likes competition in his own backyard, but we should fight for implementation for competition rules.

Anna Fornalczyk, Remarks Before Conference on the Second Anniversary of Establishment of the Antimonopoly Office (Apr. 1992, Warsaw).

prices of imported food, by means of complicated formulae, allegedly to the level of the cost of Polish production for the same product. The Antimonopoly Office had no legal authority to prevent this regulation, or even to comment on it. But the Executive Director of the Office, Ryszard Hoffman, gave interviews with the leading Polish newspapers and said that the complicated equalizing tariff proposal could be summarized in three short points: (1) The Minister of Agriculture is made governor-general of all agricultural markets. (2) He will exercise this authority in consultation with the farmers' union. (3) Consumers are free to decide whether to eat or not.³⁷ Ridicule worked, and the proposal was dramatically cut back. The question for Rodriguez and Williams is whether Polish consumers are better off because there was someone with the background, the instincts, and the platform to make those points.

There is no question that competition advocacy can be a difficult task. Despite their pessimism, Rodriguez and Williams make useful suggestions for focusing and improving such efforts. But their ultimate pessimistic conclusion is simply too defeatist. Competition advocacy can be valuable, if the advocates have reasonable goals and concentrate on them.

III. Summary

Cartelization can harm consumers, whether or not there are trade barriers. Thus, preventing cartelization is a reasonable task for a competition agency. Competition advocacy, too, if not judged by an excessively harsh standard, will be seen as an appropriate task for a competition agency. Antimonopoly agencies that work toward preventing cartelization and advocating competition can benefit consumers in economies in transition.

³⁷ See A. Gąsiorowski, *Minister rolnictwa na gubernatora*, GAZETA WYBORCZA, Nov. 4, 1992; M. Urbaniak, *Jego Wysokość Minister*, GAZETA BANKOWA, Nov. 5, 1992; J. Paradowska, *Przegald Prasy*, POLITYKA, Nov. 6, 1992.

