Two arguments for a limited implementation of antitrust standards for IPR-related deals in emerging market economies

Alexander KURDIN (corresponding author)

Research fellow at the Chair of Competition Policy and Industrial Policy, Department of Economics, Lomonosov Moscow State University, Moscow, Russia; Research fellow at the Center for Competition and Economic Regulation Studies, The Russian Presidential Academy of National Economy and Public Administration, Moscow, Russia.

E-mail: aakurdin@gmail.com. Postal address: 29-3-28, Michurinsky pr-t, Moscow, 119607 Russia. Phone: +79104623441.

Andrey SHASTITKO

Professor, Head of the Chair of Competition Policy and Industrial Policy, Department of Economics, Lomonosov Moscow State University, Moscow, Russia; Director of the Center for Competition and Economic Regulation Studies, The Russian Presidential Academy of National Economy and Public Administration, Moscow, Russia.

E-mail: aes99@yandex.ru. Postal address: Economic Faculty, 3rd new academic building, Lomonosov Moscow State University, Leninskiye Gory, GSP-1, Moscow, 119991 Russia.
Two arguments for a limited implementation of antitrust standards for IPR-related deals in emerging market economies

The transfer of intellectual property rights (IPR) and associated relations are subject to regular antitrust policy in the developed economies, with some minor refinements. The application of antitrust policy to the same area in the developing countries is a question of controversy. Such economies as China and Russia apply explicit exceptions for IPR-related deals in their antitrust laws. The authors of the article consider alternative options of antitrust policy for IPR-related deals in emerging market economies and provide rationale for weakening of antitrust standards under certain conditions. This rationale is based on the goal of structural adjustment of the economy and on the prevention of undesirable growth of uncertainty affecting the choice of governance structures.

Key words: antitrust policy, intellectual property rights, developing economies, emerging market economies.

JEL codes: L40, O38, K21.
Introduction

There are no general exceptions for intellectual property rights (IPR) as the scope of antitrust rule formulation and enforcement in jurisdictions with developed economies is concerned. Only one difference is in the way of enforcement. Emerging market economies (EME) adopting antitrust legislation recently confronted with the issues: whether to replicate approaches of developed jurisdictions (like USA or EU) or to find their own way to manage issues with IPR protection by ‘fine tuning’.

The main purpose of the paper is to show obstacles for import of institutions for emerging market economies in particular set of economic exchanges. In line with this idea arguments for limited implementation of antitrust standards for IPR-related deals in EME are elaborated. The first part of the paper is devoted to the review of literature. The second part contains the description of specific problems related to regimes of IPR protection. The third part is addressed to the interpretation of argument presented through the lens of Economics of Organization. The fourth part concludes.

1. Review of literature

The relationship between competition, innovations and IPR protection has been thoroughly investigated during several decades by numerous researchers. The subject of controversy is the role of market structure in the dynamics of innovations. Main approaches are often attributed to the works of Schumpeter (1942) and Arrow (1962), which formulated principal arguments for positive roles of monopolistic and competitive environments respectively. It may be modified in terms of the monopolistic position of the innovator if her IPR are protected by patent or copyright. There arises the ‘dilemma of the patent system’ (Tirole 1994, p. 390) as a choice between strong incentives provided by IPR-based temporary monopoly and a fast diffusion of
innovation without a strong IPR protection or with antitrust-based restrictions of IPR. Without focusing on the details of that discussion we refer to the books by Aghion and Griffith (2005) and by Etro (2007) summarizing main theoretical models and empirical evidence at the time. Following that research, we presume that the best option will be to join with Shapiro (2012) in his conclusion that there is no actual controversy between the two abovementioned approaches but the contestability as well as the existence of the innovator’s rent (exceeding the profit of the competitor) are necessary for innovations.

The discussion on competition issues and IPR unsurprisingly has been underpinned by a considerable and growing array of legal cases. They have been examined mostly in the framework of legal studies, such as (Pitofsky 2001, Hovenkamp et al. 2014) or the official guidelines published by the regulators (US DoJ and FTC 2007). Of course, economists also provided valuable insights into specific issues (such as mergers enforcement in R&D-intensive industries examined by Shapiro (2012)) or specific cases (such as widely discussed Microsoft case concerning the abuse of dominance (Etro 2007, Economides 2001)).

However, the role of competition policy in IPR-related deals has been rarely seen through the lens of development economics. Several works put emphasis on the role of intellectual property rights in economic growth in general (Greenhalgh and Rogers 2010) or specifically in the catch-up development of EME (Odagiri et al. 2012) but not on the application of competition policy in the IPR area, which is only slightly touched there.

In spite of plenty economic studies on competition issues as well as IPR protection and institutional changes for EME (including post-communist economics), and antitrust and IPR protection for developed economies there is a gap in the discussion related to the ground for institutional changes – the spreading of standard antitrust rules on IPR related transactions for EME including post-communist
economies. Nevertheless, those topics are under discussion in EME countries, and main arguments often are found in the area of economic development.

2. At a crossroads for IPR protection and antitrust: challenges for EME

The evolution of competition policy in the area of IPR has considerable implications for the economic development. The importance of IPR for innovative activities is generally recognized, and the campaign against IPR violations by private agents is one of priorities for the states pretending to the innovation-based economic development or, at least, to a wide spread of modern technologies and knowledge. However, sometimes states create obstacles to the protection of the IPR-based rent themselves. The goal may be straightforward: to prevent the owner of IPR from abuse of his position, which might be dominating, or, in other words, to limit his market power and his opportunities for the rent extraction.

The recent expansion of antitrust policy, mainly following European and US standards, throughout the emerging market economies (EME), indispensably meets the emerging question: are these standards fully compliant with the existing institutional environment? The answers given by national legislature de jure and national regulators de facto are mixed. The application of competition policy to IPR is one of the clearest examples of this controversy.

The USA and the EU apply different standards themselves, and this is comprehensively studied in a wide range of works, for example, in (Glader 2006, Niels and Ten Kate 2004, Lianos and Dreyfuss 2013). These differences are intuitively connected with the different nature of legal systems and historical discretions.

However, the deviations of the EME may be much greater. This is based on two reasons. Firstly, the system of IPR protection in EME sometimes is not fully consistent with the developed economies standards and has specific features. For instance, in
Russia the IV part of the Civil code devoted to IPR issues was introduced only in 2008 (about 20 years after launching of system transformation from command to market economy). Similar state of affairs is in China developing its own antitrust legislation after more than twenty years of reforms and IPR related issues at the end of first decade of XXI century. Secondly, a higher probability of errors – both of I (wrongful conviction) and II (wrongful release of rules violator) types – by less experienced antitrust regulators may lead to the emergence of additional impediments for the spread of innovations worsening monopolistic activity deterrence capacity.

At the same time, there is a strong force promoting the adaptation of competition policy in developing economies to the developed economies standards. It is a need to attract foreign direct investments (FDI). Resulted in cost of adaptation and higher uncertainties, the peculiarities of competition policy in the country of destination may raise transaction costs and prevent some FDI inflows.

As such, there will be two kinds of compromise in the EME for the regulators trying to impose the protection of competition in the area of IPR, where the enforcement mechanisms are more sophisticated as compared with ordinary goods.

Firstly, there is a compromise between a universal access to the existing objects of IPR, on the one hand, and strong incentives for the creative process and innovations, on the other hand. The former requires to restrict the IPR owner’s rights, while the latter leads to the opposite direction by extinguishing any behavioural restrictions potentially bringing losses to the innovator. This is the regulator’s dilemma as the opposite side of the innovator’s dilemma. In principle, the only one thing is for exclusion from this dilemma when IPR owner is not innovator.

Secondly, there is a compromise between an equilibrium found in the previous case and a customary situation for the foreign parties. However, the return to the rules accepted in developed economies is not necessarily the best option for foreign investors.
due to absence or lack of some other component of institutional environment – in legislation or in enforcement.

One problem for an investor may concern excessive regulative burden in her country of origin or country with bulk of business operations, which is presumably a developed country. So, easier antitrust regime in a developing country may be a competitive advantage, which compensates other possible country-specific problems. Of course, there should be a balance in order to prevent negative influence of weak antitrust enforcement to the foreign investor herself, when she is acting as a consumer. The second problem is engendered by specific features of competition law enforcement in developing economies, which can be also different from developed jurisdictions standards. Consequently, stricter rules may be compensated (to a certain degree) by a weaker enforcement, and vice versa.

For instance, according to a press release about new TTBER (Technology Transfer Block Exemption Regulations) issued by the European Commission, ‘…[licensing] can also be used to harm competition, for instance if two competitors in a licensing agreement divide markets between them instead of competing with each other’. In the same document licensing is defended: 'The revised regime continues to reflect that licensing is in most cases pro-competitive' (European Commission 2014).

Russian law ‘On protection of competition’ follows and even strengthens this friendly attitude towards licensing agreements and states that the requirements of the articles 10 and 11 – the articles concerning main anticompetitive violations: abuse of dominance and various types of competition restricting agreements – do not extend to actions and relationships concerning intellectual property rights. Of course, these exemptions include licensing but are not limited to licensing only. However, such an approach clearly underestimates probable anticompetitive effects of improper licensing, which are mentioned by the European Commission.
The similar approach is represented in the Chinese antitrust law. The article 55 of the Anti-monopoly Law of the People's Republic of China says: ‘This Law does not govern the conduct of business operators to exercise their intellectual property rights under laws and relevant administrative regulations on intellectual property rights; however, business operators' conduct to eliminate or restrict market competition by abusing their intellectual property rights shall be governed by this Law’\(^1\). So, the regulation here is twofold. On the one hand, IPR-related deals are declared to be free from antitrust requirements, as it is in Russia. On the other hand, there is a concept of ‘abusing’ intellectual property rights, which seems to undermine (at least, partially) this freedom and to give additional discretion to the local regulator.

The synchronism of the two countries does not stop there. China and Russia are both trying to reform antitrust rules for IPR-related deals. Federal antitrust service of Russia in 2013 and 2014 promoted the withdrawal of IPR-related ‘safe harbors’ from the law ‘On protection of competition’, though those attempts turned out to be unsuccessful in late 2014 (most probably, it is not a final outcome). Simultaneously, in 2014 the Chinese State Administration for Industry and Commerce presented a draft of guidelines explaining the application of the Anti-monopoly Law of China to IPR-related deals\(^2\). It will presumably come into force in 2015. This document prohibits anti-competitive agreements concerning intellectual property rights but, at the same time, contains explicit ‘safe harbors’. The draft also clarifies that the possession of IPR does not mean market dominance and describes the legal attitude towards different kinds of practices.

Should the Russian or the Chinese law be corrected in accordance with the European or American rules?

\(^1\) http://english.mofcom.gov.cn/aarticle/policyrelease/announcement/200712/20071205277972.html
\(^2\) http://www.lexology.com/library/detail.aspx?g=35d15d4a-39b7-4c47-a71c-4845e6e737c4
The first argument is quite straightforward and is directly connected to the industrial policy issues. If the national economy is competitive in general, then the creation of exemptions for certain industries, enterprises or assets will inevitably create distortions in the allocation of resources. However, if the national economy lacks competition, the government may search for a ‘second-best’ solution. The lack of competition here is not interpreted as the evil ‘per se’, it is blamed only for the fundamentally baseless inflows and outflows of labor and capital between industries. The core reason of these flows is the opportunity of rent extraction. Strictly speaking, the rent is not necessarily engendered by the intentional market monopolization, it may be created by administrative entry deterrence or other industry-specific circumstances provoking a high level of market concentration and/or restricting the intensity of competition in domestic and global markets.

The clearest illustration of that situation may be seen in resource-abundant economies. It is usually interpreted as the evidence of the ‘resource curse’ (Auty 2001, Karl 1997, Sachs and Warner 1995). The existence of such a phenomenon is still disputable but structural imbalances in a range of resource-rich economies are obvious. Russia represents an impressive example. It is sufficient to say that in 2013 mineral resources constituted 71.6% of Russian exports. After a short decline in 2009 (because of a sharp decrease in oil prices) this indicator have not ceased to grow during four consecutive years and already exceeded pre-crisis level, despite all the rhetoric on the economic diversification, knowledge based economy and innovations based growth. And those exports, as well as domestic sales, were very profitable at least until price fall of 2014 (Table 1). Extraction of mineral resources surpasses by far other industries in terms of profitability. The exception is fishery, which can be considered as a case of administrative monopolization due to the non-market system of quota distribution between companies (FAS of Russia 2013a, 2013b).
Table 1: Profitability of sales and assets in Russian industries, 2013

<table>
<thead>
<tr>
<th>Industry</th>
<th>Profit Margin, %</th>
<th>Return on Assets, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extraction of mineral resources</td>
<td>22.1</td>
<td>11.3</td>
</tr>
<tr>
<td>Fishery</td>
<td>16.5</td>
<td>8.1</td>
</tr>
<tr>
<td>Education</td>
<td>11.8</td>
<td>5.6</td>
</tr>
<tr>
<td>Operations with real estate</td>
<td>10.4</td>
<td>0.7</td>
</tr>
<tr>
<td>Transport and communications</td>
<td>9.7</td>
<td>4.4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>8.8</td>
<td>4.5</td>
</tr>
<tr>
<td>Construction</td>
<td>8.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Public administration and military security</td>
<td>7.8</td>
<td>-7.8</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>6.5</td>
<td>6.7</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>6.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Agriculture</td>
<td>5.2</td>
<td>1.7</td>
</tr>
<tr>
<td>Health care and social services</td>
<td>4.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Production and distribution of electricity, gas and water</td>
<td>4.4</td>
<td>0.7</td>
</tr>
<tr>
<td>Financial services</td>
<td>0.5</td>
<td>2.7</td>
</tr>
<tr>
<td>Other services</td>
<td>-2.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Average for the whole economy</td>
<td>7.0</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Source: Federal State Statistics Service of Russia

The following question may arise: why the existence of more ‘profitable’ industries, even if the market structure is oligopolistic, can impede innovations? More or less convincing answer may be found in the recent cross-industry investigation in the EU (European Patent Office and Office for Harmonization in the Internal Market 2013). The authors distinguish IPR-intensive industries by estimating the usage of specific rights: patents, trademarks, designs, copyrights and geographic indicators. The industries intensively using the latter two types of intellectual rights are comparatively small: they account only for 4.2% and 0.1% of European GDP respectively, while trade mark-intensive industries account for 33.9%, patent-intensive – for 13.9%, design-intensive – for 12.8% (sets of industries are partially overlapping).

The analysis of those three biggest groups showed that the majority of IPR-intensive industries is still concentrated in manufacturing (Table 2). It means that,
firstly, manufacturing is more likely to produce innovations, as far as manufacturing requires more instruments to protect innovations, secondly, manufacturing is more sensitive to changes in IPR regulations.

**Table 2: Distribution of IPR-intensive industries by sectors of the EU economy**

<table>
<thead>
<tr>
<th>Sector \ Type of IPR in industry</th>
<th>Patent-intensive</th>
<th>Trade mark-intensive</th>
<th>Design-intensive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary (mineral resources and agriculture)</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Secondary (manufacturing)</td>
<td>16</td>
<td>13</td>
<td>16</td>
</tr>
<tr>
<td>Tertiary (services)</td>
<td>3</td>
<td>7</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: (European Patent Office, Office for Harmonization in the Internal Market 2013)

To conclude with it, we see four conditions leading to the emergence of industrial policy aspects in the area of competition policy for IPR:

- weak development of manufacturing, especially of manufacturing with high value-added, in a country;
- comparatively high potential of manufacturing in the promoting of innovation-led economic growth;
- low investment attractiveness of manufacturing, especially of manufacturing with high value-added, in terms of profitability in comparison with the primary sector, low value-added manufacturing and certain services;
- high sensitivity of manufacturing to the regime of IPR protection.

The combination of these conditions is a reason for the establishment of more IPR-friendly regulations of competition policy, including more opportunities for innovators to use their IPR without considerable restrictions, which may improve the positions of manufacturing against primary and tertiary sectors in their contest for resources.
This remedy may look like the call for monopolization of manufacturing but in practice they have little in common. Indeed, there were attempts to restrict competition in order to promote economic growth. The most prominent of them was undertaken during the New Deal in the USA in 30-ies of XX century. However, its results were mixed and doubtful (Cole and Ohanian 2004). What is even more important, the competition itself is strongly required as the incentive for innovations. The argument about the market structure providing strongest incentives and sufficient opportunities for the innovator is far from exhaustion, however, there is a strong evidence that contestability (which does not mean perfect competition) is a necessary condition for innovations (Shapiro 2012).

At the same time, fierce competition in final goods’ industries – not in the ‘intermediary’ technology transfer relations – and low entry barriers in those industries provides enough incentives to search for better solutions without hurting those who have already found a good solution. Competition between sea gulls fishing at seaside makes them better fishers – if they try to catch a fish themselves, and not to grab it from a more fortunate neighbour – or else they become good fighters (and can eventually lose a fish), which is probably not the best development for the whole population. Competition provides incentives for innovations if it eventually rewards the innovator, and does not give additional opportunities for those who are not able to innovate and try to use someone else’s results by involving antitrust bodies into competition as an instrument for property rights reallocation.

3. **IPR protection and antitrust through the lens of economics of organizations**

The protection of competition in markets for IPR-intensive goods with minimal restrictions for the owners of IPR themselves and with regulatory interventions only when markets for final goods are destroyed may be a reasonable compromise.
But there could be a considerable side effect: the modification of mechanisms of governance. Following Oliver Williamson, we recall that the choice of one or another form of business organization – or mode of governance at the level of specific transactions – is based on the combination of characteristics of transactions, such as frequency, specificity of asset and uncertainty (Williamson 1996). These characteristics may depend not only on transaction itself but also on the institutional environment, which can considerably affect the level of uncertainty. In particular, the shift of antimonopoly surveillance from the ‘innovator – producer’ relations to ‘producer – consumer’ relations may create additional uncertainty for the producer (if he is independent from the innovator), because he will meet with different standards downstream (with severe antimonopoly policy and possible pressure from the regulator) and upstream (with easier antimonopoly policy and possible hold-up problem with the supplier of innovation).

If the object protected by IPR is transaction specific, i.e. it may be used only under certain circumstances, its area of application is limited to certain products, processes or actors with limited opportunities for switching, then, according to Williamson, hybrid or hierarchy modes of governance will be preferable. Here it might be useful heuristic model by Williamson connecting level of assets specificity and uncertainty with choice of the mode of governance. When the uncertainty grows, hybrids will be gradually replaced by hierarchies or, if the initial level of specificity is lower – both by price mechanism and hierarchy (Williamson 1991, p. 292, Williamson 1996). It means that under rather high specificity of R&D product various long-term relational contracts and networks between producers and innovators may be replaced by integrated organizations. In other words, there will be a higher probability that inventors and producers will be united in a single economic firm.
Is this vertical integration fruitful for the society? Of course, it depends on the character of business. But speaking in terms of revealed preference, we can conclude that if economic agents preferred any form of governance before regulatory measures and then change their choice after the introduction of transaction cost-increasing regulations, then they evidently choose ‘the lesser evil’. In other words, if the increase in uncertainty forces economic agents to change their mechanisms of governance, those agents evidently move to a suboptimal mode of governance, which might create less favourable conditions for them as compared to ‘business-as-usual’.

That’s why, if the competition policy framework initially included the application of standard antitrust restrictions to the area of IPR; if the agents are used to these restrictions or ways of competition policies instruments application cannot be misinterpreted, so that antitrust does not increase uncertainty itself (here we base on negative consequences of uncertainty, unlike Katsoulacos and Ulph (2012) demonstrating welfare enhancing uncertainty related to rule of reason application); and if the weakening of this restrictions leads to changes in business models, then the consequences of these changes may be considered as increases in transaction costs. In this case it seems better to conserve standards of competition policy including usual antitrust restrictions for IPR-related deals.

However, if the competition policy framework didn’t initially address to the area of IPR; if the application of antitrust restrictions for IPR is not clear and may create additional uncertainty itself; and if current business models are already adapted to a high level of uncertainty, then the ‘non-introduction’ of usual antitrust restriction to the area of IPR may even prevent the rise of transaction costs.

Exactly here we come to the second argument for a limited application of antitrust standards in the area of IPR in EME: specific institutional environment described above may change costs and benefits of alternative competition policies. To
underpin this position we return to the experience of Russia. As we have already mentioned before, Russian antitrust legislation initially included reservations preventing the usage of several important points, if IPR were concerned. Russian antitrust bodies have little experience in this area, as well as corporate antitrust specialists, and the preliminary issuing of guidelines is not adopted by the Federal Antitrust Service of Russia – unlike it is done in China now. The level of uncertainty may be illustrated by the corresponding Doing Business indicator ‘Strength of investor protection index’ and a more general component ‘Protecting investors’: Russia is in the second hundred in the list of countries considered. The case in point is McDonald’s business strategy: almost three quarters of the company’s global business is held through franchising (i.e. hybrid contracts), but in Russia the first local franchisee emerged only in 2012, after 22 years of McDonald’s presence, while all the previous outlets were operated by the company itself (Gorst 2012) (so, the preference of integrated structure of governance is obvious). Consequently, here the above mentioned conditions are met, and we probably see an opportunity of the alternative approach to competition policies in the area of IPR with the emphasis on the competition in markets for final goods and weakening of antitrust restrictions in relations concerning IPR directly.

4. Conclusion

We have distinguished two arguments for the weakening of antitrust policy requirements for IPR-related deals in EME. One of them is the necessity to ease the burden of regulation in IPR-intensive industries to make them more attractive in order to detach the national economy from the primary sector and low-value-added manufacturing, acting in the framework of development economics. The second argument is based on the prevention of additional uncertainty resulting from the reform of IPR-related antitrust policies, if there were initial exceptions from antitrust
requirements, and the information support of that reform might be weak.

Two arguments on restriction of antitrust bans for IPR-related transaction do not necessarily mean the creation of a ‘safe harbour’ unconditionally and forever. Our goal was to show that here the sequence and the starting point of competition policy matter, and the universal adoption of developed economies antitrust standards may turn out to be costly for the national economy of a post-communist (and in generally – EME) country, as well as for foreign investors. That is why there is not only a sign of institutional trap but also challenges for upgrade of design for better institutions.
References


Federal Antimonopoly Service of Russia (FAS of Russia), 2013b. Andrey Tsarikovskiy: “FAS is very concerned with the absence of clear rules of the game in the fisheries industry” [online]. Available from:


