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Trade and Competition in B2B Markets

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**Trade and Competition in
B2B Markets**

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INTRODUCTION

Business to business (B2B) electronic commerce is a typical product of the information age. By the mid-1990s, B2B markets were restricted to non-Internet network transactions available only to some large firms that owned expensive electronic data interchange (EDI) systems. At the turn of the century, Deloitte Consulting had already identified over 1,500 B2B Internet exchanges around the world, Forbes.com had an online magazine on the subject, Morgan Stanley Dean Witter was forecasting a market size of US\$1.4 trillion in online purchases by 2002, and a fast growing literature was studying the legal, economic and social implications of this remarkable innovation.¹

However, from an epistemological point of view, B2B is an old-fashioned topic that can be easily treated with the support of two concepts formulated in the first part of the twentieth century. According to Coase (1937), the boundaries of the firm are defined by the difference between transaction costs and production costs, while according to Schumpeter (1942), every major technological innovation should be understood as a process of creative destruction that periodically reshapes the competition patterns of the economic system. B2B is essentially a procedure that economizes transaction costs, thus stimulating outsourcing and market expansion, but it also implies a set of competition rules that includes a new profile of entry barriers and an ambiguous impact on market transparency.

This paper discusses the competition patterns that are likely to be engendered by B2B markets and their eventual consequences at two levels: the room for anti-competitive behavior and the creation of new international trade flows. Besides highlighting some peculiarities of the diffusion process of this innovation and reviewing the evidence already available about the impact of B2B on transaction costs and trade flows, the next section

¹ See, inter alia, Shapiro and Varian (1999), Federal Trade Commission (2000), Foer (2000), Garicano and Kaplan (2000), Helfat and Raubitschek (2000), Mann et al (2000), Mattoo and Schuknecht (2000), Office of Fair Trading (2000), OECD (2000), Popofsky (2000), Posner (2000), U.S. Department of Commerce (2000), Wiseman (2000). For additional references, see the OAS Foreign Trade Information System (www.sice.oas.org/e-comm/studies.asp).

examines the role of e-commerce on the management of long-term contracts, using the auto industry as an illustration. The following section shows that the transformations provoked by B2B imply an international agenda that includes cooperation and negotiation, regional and multilateral issues, and trade disputes involving both public policies and private behavior. The final section summarizes the main conclusions.

TRANSACTION COSTS AND MARKET POWER

According to Forbes magazine, there were about 250 promising B2B firms operating in 25 different industries by February 2001.² Although the numbers presented in table 1 will certainly change in the near future, they are useful to highlight two characteristics of B2B markets. First, the scope of this innovation includes the entire economy, without exceptions, and the diffusion process has been fast not only in sophisticated industries, such as aerospace, chemicals, computers and telecommunications, but also in traditional sectors such as agriculture, construction, beverage and retailing. Second, the geographic market and the profile of B2B transactions vary according to the peculiarities of each industry. In many cases, such as aerospace, agriculture, chemicals and metals, the exchanges may include a broad range of local and international activities, from procurement, marketing and distribution to joint R&D programs and investment projects; while in other cases B2B markets may be limited to a small set of domestic transactions. In the auto industry, for instance, only two firms — Covisint and TradingCars.com — are prepared to deal with worldwide operations; all the other 12 companies are specialized in the auto parts aftermarket and the wholesale of used cars in the United States.

Measuring the impact on transaction costs is a necessary step in any economic analysis of B2B markets. Garicano and Kaplan (2000) made an early attempt in this

² “Each company was judged on its strategy, its execution, its financial staying power and its Web site. Most of the exchanges that made our list are already open for business. A few, however, are little more than bold plans with lots of potential. As older established companies enter the race, it will be increasingly difficult to tell the real B2Bs from the B2B wannabes.” (www.forbesbest.com, last visited February 28, 2001)

direction. They studied the efficiencies created by Autodaq, a Californian firm that operates in the wholesale used car auction market for large volume sellers such as rental companies and commercial fleets. In this market, whose buyers are car dealers, about 5 million automobiles are traded per year in the United States. They classified transaction costs into two categories, coordination costs and motivation costs, and the efficiencies promoted by e-commerce in three types: (a) process improvements; (b) market place benefits; and (c) indirect benefits. Coordination costs are those related to the management of the transaction, i.e. finding potential buyers and sellers, negotiating the terms of the operation and closing the deal. Motivation costs are those associated with asymmetric information and imperfect commitment.

Table 1
Forbes Best B2B Exchanges

Industry	Exchanges	Industry	Exchanges
Aerospace & Defense	9	Maintenance & Repair	10
Agriculture	15	Media & Advertising	6
Automotive	14	Medical	9
Chemicals	13	Metals	6
Computers & Electronics	26	Miscellaneous	9
Construction & Building	18	Printing & Paper	6
Enablers (*)	10	Real Estate	5
Energy & Utilities	11	Restaurants & Food Service	6
Excess Inventory	8	Retailing	9
Financial Services	8	Small Business	10
Food & Beverage	10	Telecommunications	5
Hospitality & Travel	9	Transportation & Logistics	10
Industrial Equipment	7	Total	249

(*) Enablers are firms that provide know how for creating B2B exchanges.

Source: www.forbesbest.com (last visited February 28, 2001)

They measured the process improvements by comparing the time and economic costs involved in the Autodaq Internet process with those in the physical auction process.

This comparison revealed reductions in costs in the order of 38% to 52% of the total economic cost, which in a market of 5 million cars imply potential efficiency gains in the order of \$1 billion per year. They also identified a significant enlargement of the market. The average car from out-of-California purchased on the Internet is transported a much greater distance than the average car purchased at a physical auction, creating an extra transportation cost of US\$355. This figure provides a lower bound estimate of the market place benefits created by the Internet. It also highlights another aspect not discussed by Garicano and Kaplan, which is the potential impact of B2B on international trade flows.³ The policy implications of this impact are examined in the next section.

Garicano and Kaplan did not quantify indirect benefits such as improvements in the decision-making process and changes in administrative routines, but they recognize that these benefits can be relevant too. Regarding motivation costs, their results are consistent with the opinion shared by many authors that e-commerce does not create new forms of anti-competitive behavior, nor raises any new issues that cannot be dealt with under existing antitrust laws (see OECD, 2000; OFT, 2000; Posner, 2000). However, this does not mean that there will be no room for anti-competitive behavior, and an inquiry about this possibility can be made with standard analytical tools describing the state of entry barriers, the nature of the existing informational asymmetries and the market power of incumbent firms.

Since Autodaq deals only with auction markets, it does not provide evidence to illustrate one of the most promising applications of the Internet, which is the management of long-term contracts among firms across a production chain. A good example of this type

³ This impact can be quite substantial, as the literature on the economic role of borders indicates. According to McCallum (1995), for instance, even between countries with minimal bilateral explicit trade barriers, such as Canada and the United States, domestic transactions between Canadian provinces in 1988 were 22 times larger than the corresponding figures between U.S. states and Canadian provinces. Anderson and Wincoop (2001) showed that this paradox is not indeed so spectacular, but they found that national borders reduce trade between the US and Canada by about 44% while reducing trade among other industrialized countries by about 30%. Besides transportation costs, other reasons for this phenomenon are information costs, design costs and regulatory costs.

of application is Covisint, a joint venture established in February 2000 by Ford, General Motors, Daimler-Chrysler and Renault-Nissan. Covisint is expected to become the world's largest B2B exchange, connecting the four member companies with about 60 thousand prospective suppliers. The site is prepared to handle about US\$250 billion worth of parts per year and its potential benefits include reducing model design cycles from 40 months to 15 months and eliminating about 90% of current transaction costs.

Covisint will probably solve a time-honored ambiguity of corporate strategies in the auto industry. Since the early decades of the twentieth century, automakers always oscillated between two types of long run strategy. One approach was to concentrate the firm's capabilities on the final stages of the manufacturing process, i.e. model design and assembly line, while maintaining a network of long-term contracts with auto parts suppliers. The other was vertical integration, which was in fact open-ended, as it could encompass not only the five thousand components of a car, but also go as far back as producing flat glass, steel and other basic inputs. This ambiguity was periodically revived by technical progress inside the production chain, because innovations imply temporary Schumpeterian rents to be shared between the component producer and the assembler. As Monteverde and Teece (1982) argued: "The greater is the applications engineering effort associated with the development of any given automobile component, the higher are the expected appropriable quasi rents and, therefore, the greater is the likelihood of vertical integration of production for that component." (p. 207)

Many authors have described this situation as a "hold-up problem" that may lead to inefficient results: "One party must make an investment to transact with another. This investment is relation-specific; that is, its value is appreciably lower (perhaps zero) in any use other than supporting the transaction between the two parties. Moreover, it is impossible to draw up a complete contract that covers all the possible issues that might arise in carrying out the transaction and could affect the sharing of the returns from the investment." (Holmström and Roberts, 1998, p. 74) Not by chance, Japanese firms such as Nissan and Toyota attained worldwide leading positions precisely because they were able to

overcome the hold-up problem in the early stages of their business history (see Aoki, 1988; Helper and Levine, 1992; Spencer and Qiu, 2000). While in Europe and the United States the relationships between auto producers and their suppliers have been traditionally antagonistic, the Japanese industrial system opted for cooperation, long-term commitments and tacit knowledge, which resulted in lower production costs and successful models.

Electronic commerce is already fostering new competition patterns that will change three important parameters of the hold-up problem in the near future. The first parameter is the Coasean relation (p) between transaction costs and production costs, which governs the firm's basic preferences regarding the option of *vertical integration* versus *outsourcing*. For every user of B2B exchanges, the sharp decline of p leads to a less ambiguous demarcation of the firm's boundaries, because it creates a clear-cut distinction between those activities that belong to the *intrinsic core* and those that can be treated as *ancillary capabilities*. As Langlois and Robertson (1995) explained: the intrinsic core "comprises elements that are idiosyncratically synergistic, inimitable, and non-contestable. That is, the capabilities in the intrinsic core cannot be duplicated, bought, or sold, and they combine to generate unique outcomes that are more valuable than the outcomes that the core elements could produce separately. The remainder of the organization consists of ancillary capabilities that are contestable and may not be unique." (p. 7)

The second parameter is the degree of trust that is needed to sustain long-term commitments.⁴ B2B exchanges improve the transparency of all forms of interaction between firms across a production chain, including procurement, joint R&D projects, co-ownership of specific assets and the appropriation of Schumpeterian rents. This implies better conditions for treating the production chain as a system of knowledge shared by a

⁴ The Japanese experience provides a convincing illustration of this point: "The relationship is marked by rich information sharing, including both schedules of production plans necessary for just-in-time inventory management and also details of technology, operations and costs. The automakers also assist the suppliers in improving productivity and lowering costs: technical support engineers are a major part of the automakers' purchasing staff, and they spend significant amounts of time at the suppliers facilities. All this in turn means that potential information asymmetries are reduced, which presumably facilitates both performance evaluation and the pricing negotiations." (Holmström and Roberts, 1998, p. 82)

network of interdependent producers whose common interest is to keep steady rates of innovation. The technological dynamism of this system depends upon particular modalities of learning wherein tacit knowledge plays a strategic role (see Helfat and Raubitschek 2000a). Because tacit knowledge is based on insights that are not easily incorporated into formal documents, it can only be protected by reciprocal trust, not by contracts or intellectual property rights instruments.

The third parameter is import competition. The auto industry is an international oligopoly that has been able to extract protection rents from governments worldwide for many decades, but the rates of protection started to decline during the nineties, after the end of the GATT's Uruguay Round of multilateral trade negotiations and the wave of unilateral trade reforms in developing countries. This liberalizing trend is now receiving an additional stimulus from e-commerce, particularly from B2B exchanges like TradingCars.com that are focused on the export-import business of passenger cars around the world. The automakers are reacting to the new competition pressures with two combined strategies, mergers and acquisitions on the one hand, and improving competitiveness inside the production chain on the other.⁵ As Helper and Levine (1992) have explained, when "the purchaser's product-market oligopoly rents are reduced (for example, because of the growth of import competition), the relationship-specific rents from long-term relations will become relatively more important. With a more competitive product market, the purchaser will now prefer the efficient long-term contract." (p. 567)

⁵ In the case of Ford Motor Co., for example, this type of strategy is totally explicit: "In his New Year 2000 address to employees, new (since January 1, 1999) Chief Executive Jac Nasser put it bluntly: He wanted to transform Ford into an e-business. Lots of executives talk that way, but Nasser is putting his assets where his mouth is. The redistribution of assets is already dramatic. Ford announced in April that it would return US\$10 billion to shareholders, capital that would not be needed by the new, leaner Ford. [...] While shedding physical assets, Ford has been investing in intangible assets. In the past few years, it has spent well over US\$12 billion to acquire prestigious brand names: Jaguar, Aston Martin, Volvo and Land Rover. [...] In the New Economy, quite deliberately, Ford has been selling things you can touch and buying what exists only in the consumers' minds. The corporate Ford of 2010 will look more like Cisco — a company that manufactures very little." (Jay Akasie, "Ford's Model E", *Best of The Web*, 07.17.00, www.forbesbest.com)

Besides changing the parameters of the hold-up problem, e-commerce will redesign the geographic profile of many industries. Compared with the revolutionary decline of information costs, transportation costs have changed very little over the last two decades, and this contrast has been responsible for two simultaneous trends in the world economy, one toward global markets and another toward regional production chains. The interdependence between these trends is stronger in industries like the automotive, wherein the development of new products requires a continual collaboration between the downstream firm and its suppliers on projects that may take several years to complete, implying constant unplanned staff meetings, joint training programs and other activities that become unfeasible if the partners are not located in the same neighborhood. However, devices like the Virtual Project Workspace introduced by Covisint open new possibilities for teamwork, by allowing an easy long-distance interaction among designers, engineers, managers and project leaders. This tool includes a series of features that enable team members to share 3D data and conduct virtual meetings. For example, a Web-based platform allows users to collect multi-media files regarding an issue in one secure place, set routing schedules, analyze project status and alert team members to issues that need their attention (see www.covisint.com).

Not everything will be peaceful and promising inside B2B markets. By stimulating outsourcing, long-term contracts and new international trade flows, e-commerce also creates entry barriers that may lead to antitrust litigations and trade disputes. The efficiencies generated by B2B are not always visible to outsiders because they are based in part on tacit knowledge that has been acquired through relationship-specific investments. Thus, when a downstream producer and a supplier sign a cooperation agreement, the latter firm becomes protected from potential competition by an entry barrier with two components: sunk costs and asymmetric information. To an outsider, as Spencer and Qiu (2000) already noted, this type of agreement may appear as an exclusionary practice, when it is in fact just a strategy imposed by technical progress. If the two firms are located in different countries, competitors from third countries may interpret that contract as a trade barrier. However, while an antitrust authority could easily dismiss the allegation of anti-

competitive behavior, the long-term relations fostered by B2B markets may originate legitimate conflicts of national interests, as they provide the conditions for the development of *retainable industries*. According to Gomory and Baumol (2000), market forces in retainable industries tend to perpetuate the status quo, because entry barriers allow the established producers to retain their current positions in the international market for long periods, and eventually limiting the development of those industries in other countries. “The protection is never absolute, and no industry is perfectly retainable.” (p. 17) Yet, this situation always raises complex trade negotiating issues, as the next section shows.

E-COMMERCE AND THE INTERNATIONAL AGENDA

As the preceding section showed, the development of B2B markets has three types of effects on the international conditions of competition. The first is a trade creation effect with two components, one resulting from the extended geographic area attained by auctions made over the Internet, and another from those B2B exchanges specialized in export-import activities. The second is the generation of new forms of entry barriers that may lead to retainable industries. The third is the strengthening of the market power of some downstream transnational corporations.

From the viewpoint of international relations, the aforementioned effects imply two contrasting trends, one toward trade liberalization and another toward conflicting national interests. Imagine that a downstream firm has moved to a foreign country while maintaining the links with its traditional suppliers at home, because the efficiencies allowed by their common B2B site compensate for the transportation costs and the trade barriers. With the proliferation of this type of initiatives, the existing trade barriers will be gradually transformed into transaction costs without any protection role, and therefore could be easily eliminated. On the other hand, trade disputes will tend to appear under the format of antitrust litigations, even when there are no anti-competitive practices involved, as we have seen in the preceding section. Indeed, e-commerce will simply reinforce an ongoing

trend: as Eleanor Fox (1997) noted, antitrust issues are already present on the trade negotiating agenda regarding market access in high-technology industries.

Since the beginning of the Uruguay Round, the issues on the current trade negotiating agenda have been divided into two classes: old issues (i.e. tariffs, quotas, subsidies, antidumping, safeguards, rules of origin, agricultural protectionism and the like) and new issues such as investment rules, trade in services, intellectual property rights and competition policy. However, the transformations brought about by e-commerce indicate that these two classes do not in fact belong to the same agenda, because they are linked to different vintages of conflicting interests and require different negotiating strategies. The old issues include only governmental measures that were designed to protect domestic producers from international competition patterns that prevailed during the nineteenth century and the first part of the twentieth century. Those measures created trade disputes that have been traditionally negotiated through mercantilist strategies involving the exchange of concessions. The new issues include both public policies and private practices designed to address competition patterns that emerged during the last decades of the twentieth century as a consequence of the information revolution. The traditional mercantilist strategies are useless in this case, because the conflicts involved can only be treated under a new set of domestic and international institutions and their corresponding policy instruments. For example, the infant-industry argument for protection has recuperated its intellectual legitimacy under the current competition patterns, for the reasons explained by Gomory and Baumol (2000). However, instead of any conventional trade barrier, the relevant set of protection instruments now includes a variety of subtle privileges such as facilitating Internet access, increasing public expenditures in selected basic sciences, lowering R&D costs in the software industry, redesigning environment policies and public health standards, updating intellectual property laws, etc.

Thus, a defining characteristic of the new generation of international conflicts is that they do not originate from trade policy instruments but from domestic regulations that provide the conditions for private practices that affect the interests of economic agents in

other countries. This interplay between public policies and private behavior often leads to disputes that can be solved only by a combined set of governmental negotiating strategies and cooperation efforts. Imagine, for example, that the operations of an international cartel are provoking serious damages to consumers in several countries. The elimination of these practices would require a complex cooperative effort among the antitrust authorities from all affected countries, involving synchronized investigations, exchange of sensitive commercial information, adoption of common approaches on the definition of relevant markets, similar methodologies for assessing damages and a common view about the remedies to be applied in each country. An obvious assumption underlying this exercise is that all the affected countries have the necessary financial resources, human capital and legal instruments to carry out the initiative. However, even if these conditions are attained, those countries will face another obstacle before solving the cartel problem. Despite the common goal of promoting consumer welfare, the net benefits of the initiative will vary across countries, since the balance between monopoly rents and consumer losses will depend upon the geographic profiles of manufacturing, distribution and consumption of the goods produced by the cartel. As the unequal distribution of benefits will become transparent during the investigation, the participating governments will be compelled into a simultaneous exercise of cooperation and negotiation.

This exercise will turn still more challenging in cases involving aspects of the information revolution, due to the technical complexity of the issues and the time constraints imposed on the authorities' decision-making process. As Richard Posner (2000) pointed out, if the antitrust agencies do not move fast enough, the speed of technical progress in the information industry may turn a case irrelevant by the time the authorities have concluded the investigation. His analysis is focused on the current conditions for domestic enforcement in the United States: "A further complication is that it is difficult to find truly neutral competent experts to advise the lawyers, judges, and enforcement agencies on technical questions in the new economy. There aren't that many competent experts, and almost all of them are employed by or have financial ties to firms involved in or potentially affected by antitrust litigation in this sector. The Antitrust Division does not

employ *any* computer scientists or electrical engineers, but is wholly dependent on consultants, as are also, I believe, all the state antitrust offices; and, as I say, it is difficult to find a consultant in the new economy who is both competent and disinterested.” (p. 8)

Although this problem may eventually fade away in the United States, it will certainly remain on the international agenda for a long time because most countries are yet to start facing it. Nowadays, about half of the members of the World Trade Organization have antitrust laws, but only OECD countries and a very small number of developing nations (perhaps less than ten) have institutions prepared to enforce those laws. Without national institutions, a country is unable to play any substantive role in the debate about multilateral rules for competition, and has a limited power to protect the national interest in other basic areas of the new international agenda, such as intellectual property, investment and services. Competition policy is the starting point for a coherent stance in all three areas. A sound intellectual property law should preserve the incentives to innovate while controlling the sources of anti-competitive behavior, and a similar balance should be achieved when protecting the rights of foreign investors (Pitofsky, 2001; Robert, 2001). In the area of services, trade liberalization implies transparent rules for monopolistic sectors such as telecommunications, energy, transportation and financial services (Stephenson, 2001).

Besides creating new institutions, another challenge yet to be faced by many countries, including the United States, is the reform of old institutions, as the case of antidumping illustrates. The conflicting goals of antitrust and antidumping are well recognized in the economic literature,⁶ but in the United States these policies shared a peaceful division of labor throughout the twentieth century. In fact, the first Antidumping Act was passed in 1916 as a complement to the Clayton Act of 1914, which proscribed price discrimination in the domestic market, but without a corresponding discipline for imported goods. Nevertheless, in the following decades, the U.S. International Trade Commission (ITC) was not engaged in the enforcement of competition policy, together

⁶ See Tavares, Macario and Steinfatt (2001) for a survey of this debate.

with the DOJ Antitrust Division and the Federal Trade Commission (FTC). Instead, a more subtle relationship was established among these agencies. While competition policy remained under the responsibilities of the Antitrust Division and the FTC, the role of the ITC was to provide a temporary relief to those industries unable to face import competition. But curiously, the firms protected under antidumping measures were seldom involved in antitrust cases.⁷

As the foregoing discussion has showed, antidumping is useless for protecting domestic firms from the competition patterns engendered by the information revolution. Henceforth, the role of the ITC needs to be revised, and this may imply an intricate political debate. The ITC is an independent, bipartisan, quasi-judicial federal agency that makes recommendations to the President, the U.S. Trade Representative and the Congress on trade policy matters. It is headed by six commissioners — three democrats and three republicans — and has a staff of about 360 professionals. The commissioners serve overlapping terms of nine years each, with a new term beginning every 18 months. Besides antidumping cases, the Commission has other activities such as investigations on the infringement of intellectual property rights by imported goods and economic research on trade policy matters; but it does not participate in trade negotiations.

CONCLUSION

The economies of transaction costs promoted by B2B markets have been so exceptional that they are destroying the protection power of traditional trade barriers such as tariffs and antidumping actions. But instead of free trade, the ultimate effect of B2B is to foster a new generation of international conflicts that can only be negotiated under an institutional framework that is yet to be created. As the foregoing discussion suggested, the

⁷ In a previous paper, I compared the list of goods involved in 223 cases investigated by the Antitrust Division during 1994-98 with the 348 antidumping and countervailing measures that were active in the United States by December 1997. Both lists had just *one* item in common, ferrosilicon, which is an alloying agent that improves the finished properties of steel products. There were three cases of price fixing among U.S. manufacturers of this good, and five antidumping actions against exporters from Brazil, China, Kazakhstan, Russia and Ukraine. (See Tavares, 1998)

current fragility of the multilateral trading system probably will be long lasting, because its elimination depends upon difficult reforms in many countries. In some cases, the reforms include the establishment of sophisticated institutions in developing countries that do not have human, legal and economic resources to carry out the initiative. In other cases, embracing both industrialized and developing economies, the reforms may imply a divisive political debate about the redesign or eventual abolishment of traditional domestic institutions.

This uncertain environment offers new opportunities for regional institutions. First, because the competition patterns of the new economy reshape the discussion about multilateralism versus regionalism, wherein the central topic is not trade creation versus trade diversion anymore, but the demarcation of relevant markets. Many B2B marketplaces are local, some are regional and only few are global. So, most often a regional institution will be the appropriate negotiating forum for dealing with the trade disputes. Second, because intellectual property, services, investment and competition policy are already on the agenda of the ongoing regional arrangements, thus providing interim solutions that may pave the way to the reform of the multilateral system. Nevertheless, the problem here is that in many regional initiatives, such as the Common Market of the South (Mercosur), the European Union-Mercosur negotiations, the Free Trade Area of the Americas (FTAA) and others, the old issues continue to attract more attention than the new ones.

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