

# European Antidumping Policy and firms' strategic choice of Quality

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## **Abstract**

In this paper, we consider a European industry characterized by vertical product differentiation. Using a two-stage model with quality choice made before price competition takes place, we show that EU anti-dumping policy that takes the form of price-undertakings offers a powerful protection to domestic firms, but only at the price competition stage. Once the impact of the A-D policy on quality choices is taken into account, European Welfare as well as profits accruing to the domestic firm decrease whenever the free trade equilibrium is affected. Hence we show that European Antidumping policies may induce "perverse" leapfrogging.

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# 1 Introduction

According to the European anti-dumping legislation (A-D policy hereafter), whenever a foreign product, which is "similar" to a European one is "dumped" on the European market, trade protection can be imposed (EC regulation 386/94). The procedure follows two main steps. Assuming dumping (i.e. price discrimination between national markets) has been established,<sup>1</sup> the legislation aims at eliminating price-undercutting of European products in the European market. This protectionist policy is justified by the idea that dumping should be viewed as unfair competition, so that the resulting "injury" caused to the European industry must be compensated for. More specifically, the A-D policy aims then at eliminating the injury as measured by the extent of the "injury margin", grossly defined as the extent of foreign price-undercutting in the European market (Vermulst and Waer (1991)). In order to eliminate the injury, the Commission may either impose a duty or accept a price-undertaking. Price-undertakings are best viewed as commitments by the foreign competitors to match the price of the European product in the European market. A price-undertaking forces the foreign firm to 'meet' the price set by the European producer of the 'like product' in the European market. In this paper we focus on antidumping protection taking the form of price-undertakings which is arguably the most popular type of antidumping measures used by the European Commission.<sup>2</sup> According to Tharakan (1994), undertakings have accounted for about 72 per cent of the antidumping/countervailing duties cases terminated by the European Commission during the period 1980-87. Tharakan (1994) identifies a variety of reasons for such a marked preference. According to his empirical analysis, trade policy considerations seem to play an important role in the choice between undertakings and duties.

The way the European Commission calculates the injury margin in European antidumping cases has often been criticized.<sup>3</sup> Moreover, the relation between observed price-undercutting

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<sup>1</sup>Legal dumping occurs whenever the price charged by a foreign producer on its own market is higher than the price charged in its export market (in the present case the European one).

<sup>2</sup>The case of a duty will briefly be discussed in the paper but results under a duty will appear to be quite similar to those obtained under price-undertakings.

<sup>3</sup>Vermulst and Waer (1991) offers a detailed analysis of the difficulties as well as of the possible arbitrariness involved in computing injury margin.

and real dumping is subject to criticism. Veugelers and Vandebussche (1999) for example have shown that foreign price-undercutting can be the result of a cost advantage of a foreign firm selling a differentiated product on the EU market. Foreign price-undercutting then reflects a competitive advantage rather than unfair trade practices by the foreign importer. This note aims at putting forward an additional argument that shows the perverse effects induced by the policy and casts doubt on the economic rationale of the injury determination.

According to the regulation, the legislator allows for price differences between a European and a foreign product when they differ in characteristics (EU regulation 386/94 §3 section D.10). There are however cases where quality differences between domestic and foreign products are acknowledged, but no price adjustments were made. For example in 1987, a Russian importer of 'standardized electrical motors' in the EU was accused of dumping and injury to the Community industry because of selling at a lower price than the European standardized electrical motors. The Russian exporter argued that the Commission when making a price comparison between European motors and Russian motors, should take into account *'the differences in physical characteristics, the poor brand image of USSR products, the lower quality of raw materials and the lower efficiency of after sales service compared to Community products'* (L 83/4 27.3.'87). A (former) GDR exporter of motors equally alleged of dumping and injury in the same case, pointed out to the Commission that *'its products contained a lower active material content than most motors manufactured by Community competitors'*. Furthermore it was argued that there were other technical differences between the motors such as *'electricity input, axle height, noise and vibration levels of motors'* which should be taken into account when comparing prices (L 83/4 27.3.'87).

In response to these objections the Commission replied that *'these differences did not affect price comparability and therefore no allowances were made'*. More in particular, the Commission argued that *'given the large degree of international standardization in the manufacturing of such motors, each type of motor originating abroad constitutes a 'like product' to the same type of Community standardized motor, although there may be differences in quality'* (L 280/69, 1.10.'86).

Other cases involving obvious quality differences can of course be found. See for instance

case 3651/88 involving Japanese dot matrix printers (Official Journal of the EC, L 317/33-44, of date 24.11.1988) or case 3946/88 involving polyester yarn from the US, Mexico, Taiwan and Korea (Official Journal of the EC, L 348/49-55, of date 17.12.1988).<sup>4</sup> While a more systematic treatment of such cases seems called for, it lies beyond the scope of the present paper. It is our belief that the cases listed above illustrate the Commission's general position towards dumping cases involving quality differences<sup>5</sup> These cases clearly show that the Commission can acknowledge the difference in quality that may exist between the foreign and European products, but nevertheless decide to consider the products as similar. This implies that a lower price for the foreign product in the EU market is considered to be injurious for the European industry and antidumping protection aimed at offsetting this price difference follows. They also show that A-D policies may be implemented even though products are viewed as differing in quality. Interestingly enough, the kind of "differences" mentioned in this case falls into the definition of what are viewed as vertically differentiated goods. Hence, studying the implications of such policies on quality choices is more than a purely academic exercise.

The argument developed in the paper can be summarized as follows. Let us suppose that products exhibit different, but sufficiently close, quality levels. When products are vertically differentiated, equilibrium prices reflect quality levels. So, a foreign producer selling a low quality good must charge a low price in the EU market in order to enjoy a positive market share. If the foreign product is considered to be "similar" to the European one by the European Commission, the foreign producer runs the risk of being subject to a price-undertaking under the EU antidumping laws. As a consequence, if forced to match the European price, the low quality foreign product may not survive in the market. *This risk spills over to the quality decision stage.* We will show that with a price-undertaking, the foreign producer is less inclined to adopt a low quality profile. As a result, both firms' incentives with respect to quality choices are directly affected by the mere threat of A-D actions at the price competition stage.

Relying on this intuitive argument, we analyze the effects of price-undertakings on price competition and quality choices when vertically differentiated products are likely to be considered

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<sup>4</sup>Mc Gee (1996) mentions several cases involving direct comparisons of product exhibiting objective quality differences.

<sup>5</sup>Thusfar, there is no indication to suggest that the Commission's policy in this respect has changed over time.

as ‘similar’ in an antidumping investigation. Note that if ‘similar’ only refers to horizontally differentiated goods, than foreign importers of vertically differentiated goods should not worry about the Antidumping laws in place. As soon as they can show that the product they sell is of ‘lower quality’ than the European one, they should be allowed to charge a lower price. However, as shown by the previous examples, recent evidence does suggest that the definition of ‘similar’ can involve vertically differentiated (quality differences) goods.

In what follows we shall model demand for vertically differentiated products along the lines developed by Mussa and Rosen [1978]. We will show that although the price-undertaking relaxes price-competition for the domestic firm when qualities are given, *Equilibrium quality choices are affected in a way which always results in a reduction of European Welfare as compared to free trade.* The reason is that the presence of a price-undertaking tends to make the foreign firm more aggressive in the quality game. When under free trade the foreign firm is a low quality producer, a price-undertaking will turn it into a quality leader in the market. To adopt low quality is no longer profitable when price-undertaking is in place. This implies that the domestic European firm now faces a more aggressive opponent at the quality stage and is the one which is the more prone to adopt a low quality. Our findings suggest thus that a price-undertaking can lead to a reversal of the quality ranking, where the long-run foreign quality is upgraded and the domestic one downgraded compared to free trade. Domestic Welfare then decreases because of a larger profit diversion effect. In this respect, we may argue that anti-dumping policy tends to induce ”perverse” leapfrogging in vertically differentiated industries. Hence, when the European Commission constructs anti-dumping measures that are aimed at offsetting foreign price-undercutting without accomodating for the fact that qualities are affected, long-run European Welfare may fall. Quality upgrading of foreign imports as a response to the imposition of a quota or a VER is a documented fact.<sup>6</sup> The theoretical analysis of this paper suggests a similar phenomenon of quality upgrading when imports are subject to anti-dumping measures. Empirical validation of this prediction is called for in future research.

In the next section we present a stylized model of vertical product differentiation and characterize the associated subgame perfect equilibria under free trade. We then study the same

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<sup>6</sup>See Feenstra (1988) for evidence under VER and Aw and Roberts (1986) under a quota.

two-stage game in the presence of a price-undertaking. The subgame perfect equilibrium of the modified game shows how quality choices and price competition are altered in the presence of antidumping protection. In section 3, we comment on our main results and look at their robustness. Section 4 concludes.

## 2 The Model

Let us consider a duopoly where a European ( $D$ ) and a foreign firm ( $F$ ) sell vertically differentiated products in the EU market only. Firms choose quality in the first stage (long run) and compete in prices in the second stage (short run).

Consumers in the European market are willing to buy at most one unit of the good and exhibit heterogeneous preferences. More specifically, they are identified by their taste for quality  $x$  which is uniformly distributed on the interval  $[0, 1]$ .<sup>7</sup> The net utility of consuming good  $i$  for the consumer with taste  $x$  is  $u^i = x \cdot s^i - p^i$ , where  $u^i$  refers to consumers' utility,  $s^i$  refers to the quality and  $p^i$  refers to the unit price of good  $i$ . We set the default utility of no-consumption to zero. With respect to quality choices in the first stage, we assume that  $s^i \in [0, 1]$ . In order to keep the exposition as simple as possible, we assume zero cost for quality in the first stage and zero production cost in stage 2. Neglecting costs mainly allows us to highlight those effects that are exclusively imputable to price competition and in particular to the way price-undertakings distort the price game. Once this mechanism, which is independent of quality costs, has been revealed, the role of such costs becomes relatively straightforward. We postpone until section 3 a thorough discussion of this assumption. Let us stress however that relaxing this assumption would not affect the *qualitative* implications of our results.

### 2.1 The Free Trade Equilibrium

Under the assumptions stated above, it can be shown that in the absence of trade policy there exist two subgame perfect equilibria in pure strategies: one firm sells the best available quality product and the other firm chooses an optimal degree of product differentiation, i.e. sells a low

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<sup>7</sup>Note that our assumption on the distribution of consumers' type ensures that the market is not covered in equilibrium.

quality product. In the continuation price equilibrium the price of the high quality product is higher (i.e.  $p^H > p^L$ ) so that both firms enjoy a positive market share. This standard result is summarized in the following lemma.

**Lemma 1** *In the quality-price game, there are two subgame perfect equilibria. The high quality firm chooses the best available quality (i.e.  $s^i = 1$ ) while the low quality firm differentiates to a ratio of 4/7. In all price subgames the equilibrium is unique and in pure strategies.*

In the appendix we develop the argument that leads to Lemma 1 but since this result is fairly standard we omit a full proof.<sup>8</sup> As they stand, the particular value of qualities in equilibrium essentially reflect the normalization we have made so that Lemma 1 should not be taken literally. Note however that the existence of an optimal degree of differentiation and the multiplicity of equilibria are robust results.

The following comments are in order. First, under free trade, product differentiation always prevails in equilibrium. For the firms it is never optimal to choose identical qualities because this would lead to pure Bertrand competition, i.e. zero profits for both. Note however that from a domestic Welfare point of view, the first best precisely involves both firms choosing the best available quality and naming a price equal to marginal cost. Since we have just seen that in a Subgame Perfect Equilibrium, product differentiation prevails, Domestic Welfare is lower as compared to the first best for three main reasons. First, there is under-provision of quality. Second, because of product differentiation, price competition is relaxed, so that equilibrium prices are above marginal costs and some of the consumers refrain from buying any of the two products: given product qualities, prices are too high. Third, the foreign producer always makes positive profits, which do not enter domestic Welfare. We will define the part of the industry's profits that goes abroad the profit diversion effect. Due to this "profit diversion" effect a domestic government is not indifferent between the two Subgame Perfect Equilibria (SPE hereafter) identified in Lemma 1. The equilibrium where the domestic producer is the quality leader is strictly preferred.

Under free trade, two quality rankings are possible in the pricing subgames. Either the domestic firm is the high quality producer and the foreign firm is the low quality producer

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<sup>8</sup>The interested reader is referred to Choi and Shin (1992) or Wauthy (1996) for a full proof.

( $s^D = 1, s^F = 4/7$ ) or vice versa ( $s^D = 4/7, s^F = 1$ ). It is only in the former case that the foreign firm runs the risk of being subject to the EU's Antidumping legislation. In the case where it produces the high quality product and hence charges a higher price in the EU market there is no foreign price-undercutting and thus no risk for the A-D legislation to apply. A first result emerges: antidumping policy cannot affect price competition in the cases where the foreigner is the quality leader. Hence we focus hereafter on the pricing games where the domestic firm sells the high quality product and the foreign firm sells the low quality product. We keep in mind however that the alternative quality hierarchy remains an equally likely candidate SPE.

## 2.2 Price-Undertakings and Quality choice

Let us assume that the European authorities have decided on an antidumping law at time  $t = 0$ . The terms of the law are the following ones. First, a domestic firm is allowed to file a complaint in case of dumping. Following Veugelers and Vandebussche (1999) we do not explicitly model the existence of dumping and just assume that price discrimination between the foreign market and the EU market prevails whereby the price on the EU market is the lower one. There are of course a variety of reasons combining supply conditions and differences in demand and competitive conditions in the respective markets that could support such a situation. For instance, even though demand is lower in the local market (which may typically be the case for less developed exporting countries), the foreign firm could benefit from a domestic monopoly position which allows it to charge a higher price in its local market than abroad. When dumping prevails, the government will then evaluate the injury. This injury is defined as the positive difference between domestic and foreign prices. In case the European and the foreign product are considered as 'similar' products and injury is detected, either a price-undertaking or a duty on imports is implemented. The discussion of a duty is left for section 3. A price-undertaking by definition consists in a commitment by the foreign firm to match the domestic price. A penalty is imposed on the foreign firm when the injury is not eliminated.

Formally, under a price-undertaking, the low quality foreign firm's best reply consists in matching the domestic price, i.e.  $p^D = p^F$  (see Veugelers and Vandebussche [1999]). Given the previous specification of the anti-dumping policy, they both anticipate that whenever  $s^F \geq s^D$ ,



the continuation price equilibrium does not lead to injury whereas it is always likely to do so under the alternative quality hierarchy. Specifically, with the foreign firm selling the low quality product, the antidumping law comes into play and affects the free-trade outcome when products are ‘similar’. To capture this in our model, we parameterize the ‘degree of similarity’ between the vertically differentiated goods by  $\Delta$ . By definition,  $\Delta$  identifies the largest quality differential which would lead the Commission to consider that products are similar. We have assumed that the quality chosen by either of the firms is indicated by  $s$  ( $s^i$  with  $i = D, F$ ) which can lie between zero and 1. The widest possible interpretation of ‘similarity’ then involves a value of  $\Delta = 1$ . This implies that whatever the quality difference between the European and the foreign product on offer, the European authorities will always consider the two as ‘similar’. We will first consider the case where  $\Delta = 1$ . This represents the most extreme case and as such will exaggerate the likely impact of the policy. However, it also provides a suitable benchmark for less extreme situations in which  $\Delta < 1$ , as discussed in section 3.

In order to study the impact of the price-undertaking on quality choices, we first characterize equilibrium in price subgames which are subject to the price-undertaking.

### 2.2.1 The second Stage: best replies in prices

Recall that the only price subgames that are affected by the EU policy are those where the foreign firm is the low-quality firm. In these cases, under free trade, the foreign firm will always set a price lower than that of the domestic firm.<sup>9</sup> In particular the free trade best reply for the low quality firm always consists in choosing an optimal discount on the high quality product’s price. Thus, any possible free trade best reply causes “injury”, i.e. under the assumption that price-undercutting leads to a price-undertaking, the foreign firm is always constrained in the price competition stage. Whatever the price set by the domestic firm, the foreign firm will have to respect the price-undertaking by meeting the European price. It follows from the definition of vertical differentiation that in this case, the foreign firm cannot enjoy a positive demand and thus earns zero profits: since it sells a lower quality product at the same price than the domestic firm, all consumers will prefer the high quality product. Therefore, a price-undertaking

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<sup>9</sup>See the appendix for a detailed analysis.

turns the domestic producer into a monopolist whereas the profits of the foreign firm under the undertaking is invariably nil when it sells a strictly lower quality. The optimal price for the domestic firm is the monopoly price. Since the foreign firm is forced to match this price despite its lower quality, the domestic firm enjoys the full monopoly profits.

As mentioned previously, assuming that  $\Delta = 1$  leads to the most extreme form of protection: *a price-undertaking is beneficial at the price stage to the domestic firm by completely relaxing price-competition in the market*. However, we will now argue that in the long run, the conclusion is reversed.

### 2.2.2 The first Stage analysis: best replies in qualities

We only need to study the best replies in quality under the hierarchy  $s^D \geq s^F$ . Recall indeed that in the alternative hierarchy, anti-dumping is ineffective, so that the analysis of quality choices exactly replicates the free trade one: against a high foreign quality, the domestic producer optimally differentiates with a lower quality. Therefore  $(s^D = 4/7, s^F = 1)$  remains a SPE of the full game with price-undertaking. We consider now the alternative hierarchy. From the analysis of the price subgames we know that in the presence of a price-undertaking, the European producer becomes a monopolist whenever it sells the high quality. It is immediate to show that in this case its best reply in quality is independent of the other's action and consists of choosing the highest possible quality. Therefore against any  $s^F < 1$ , the best reply of the domestic producer is  $s^D = 1$ . On the other hand, against  $s^F = 1$ , the domestic firm is better off differentiating. Recall indeed that if products are identical there exists a unique symmetric equilibrium (the pure Bertrand equilibrium) in the corresponding price subgame where no injury prevails.<sup>10</sup>

To choose a lower quality like in the case of free trade is no longer optimal for the foreign producer. If it were to do so its market share in the pricing game would be zero under a price-

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<sup>10</sup>Note that even if we assume that a price-undertaking applies in the case of homogeneous products, the unique equilibrium is still the Bertrand equilibrium exhibiting marginal cost pricing. The reason is that although the foreign firm can no longer undercut, the domestic firm still can and finds it profitable to do so. Any price differential is matched by the foreign firm whereas any tie is undercut by the domestic one so that the unique equilibrium is the zero-profit one.

undertaking. Matching the domestic quality results in a zero profit outcome, i.e. zero profits. By slightly improving upon the domestic quality, the foreign firm can secure positive profits. In other words, under the hierarchy  $s^D \geq s^F$ , the foreign best reply is invariably  $s^F = s^D$ . But we also know that foreign profits are increasing at  $s^F = s^D$ . From the free trade analysis, we know that the payoff of a high-quality firm is monotonically increasing in its own quality. In other words, because of the price-undertaking, the foreign firm is always better-off by matching and even improving upon the domestic quality. Its best reply is then invariably equal to 1, whatever the domestic quality.

The previous analysis of the best replies at the quality stage of the game shows that in the presence of the price-undertaking there is a unique SPE exhibiting  $(s^D = 4/7, s^F = 1)$ , i.e. the equilibrium in which the domestic firm optimally differentiates with a lower quality. We have therefore established the following proposition.

**Proposition 1** *When the foreign product is regarded as ‘similar’ to the European product regardless of the quality difference between them ( $\Delta = 1$ ), European Antidumping Policy taking the form of a price-undertaking induces the unique subgame perfect equilibrium  $(s^D = 4/7, s^F = 1)$*

An immediate corollary is then established.

**Corollary 1** *The price-undertaking leads to a lower expected domestic Welfare.*

The proof of the corollary is straightforward. We only have to compare the unique equilibrium induced by the possibility of a price-undertaking, henceforth the ‘undertaking’ equilibrium  $(s^D = 4/7, s^F = 1)$  to the two equilibria applying under free trade:  $\{(s^D = 1, s^F = 4/7), (s^D = 4/7, s^F = 1)\}$ . Note first that consumers are indifferent as to who is selling what so that the two equilibria are strictly equivalent from a European consumer Welfare viewpoint. The only difference comes from the fact that the high quality firm makes higher profits. Therefore, whenever the foreign firm is the high quality firm, domestic Welfare is lower because more profits go “abroad”. We note then that the anti-dumping policy precisely selects as the unique possible equilibrium, the equilibrium which sees the foreign producer as the quality leader, i.e. the one involving the lower domestic Welfare. It follows that the expected domestic Welfare must be

lower in the presence of antidumping than without it since the probability of seeing the domestic firm selling the high quality product is nil under the AD policy.

The protection offered to the domestic firm by a price-undertaking applies only at the price competition stage. But the relaxation of price competition has long run implications. As a result of the price-undertaking, the foreign firm cannot survive with a lower quality. The only way out is to be more aggressive at the quality stage. The price-undertaking allows the foreign firm to credibly *commit* to the best available quality, against any possible quality chosen by the domestic firm.

### 3 Comments

The result established in Proposition 1 result can be compared to Bocard and Wauthy (1998) where it is shown that a quota on foreign imports, which relaxes price competition in the last stage also results in more aggressive behaviour in the quality stage by one of the firms. In the case of a quota however, it is the domestic firm which behaves more aggressively thereby leading to a Welfare *increase* for the domestic country.

Proposition 1 is also reminiscent of some results obtained in the literature on Leapfrogging, as surveyed for instance by Herguera and Lutz [1998]. This literature essentially focuses on the conditions under which a domestic government can induce leapfrogging by the *domestic* firm in equilibrium through an adequate choice of policy instruments (subsidies, tariffs, quota, or minimum quality standards). In our paper, "perverse" leapfrogging occurs as a result of AD policy, turning a low quality foreign firm into a high quality one. Note that here, leapfrogging is an *undesirable side-effect* of the anti-dumping policy whereas domestic leapfrogging is the objective pursued by governments in Herguera and Lutz [1998]. In fact, we have shown that the price-undertaking leaves no other choice for the foreign firm than to leapfrog the European one. As pointed out by a referee, the leapfrogging issue is even more relevant under a sequential setting with the domestic firm playing first.<sup>11</sup> Assuming again that quality is costless<sup>12</sup> the

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<sup>11</sup>See Donnenfeld and Weber [1992] for a general treatment of sequential entries in vertically differentiated industries

<sup>12</sup>The case of positive costs is considered below

domestic firm would always choose the high quality under free trade whereas in the presence of the price undertaking, it would choose the low quality one, i.e. leapfrogging would always occur.

Overall, the idea that trade policy affects quality choices made by the firms, and more specifically result into quality upgrading by importers is supported by several recent empirical studies. Feenstra (1988) showed that under the US VER between 1981 and 1985, both the price and the quality of Japanese cars were affected by the presence of the VER. Aw and Roberts (1986) evaluating the 1977-81 quota on footwear from Korea and Taiwan find that the quota lead to the quality upgrading of most import bundles throughout this period. No such empirical evidence exists yet for the case of price-undertaking. In this respect our analysis suggests that similar effects could be observed. It is moreover worth reminding that a price-undertaking are often viewed as a VER "in disguise". In fact, after multilateral trade talks at the WTO, the use of tariffs and VERs has been reduced or abolished. However they have been replaced by "new" types of protection, mainly in the form of antidumping duties and price undertakings<sup>13</sup> which are generally regarded as less transparent and far more selective.

Since our results have been derived using a very stylized model, we discuss now the implications of relaxing several of our assumptions. The qualitative implication of proposition 1 holds true under more general settings. Anti-dumping policies of the type we have discussed are very likely to be Welfare decreasing once its impact on quality choice is fully taken into account.

Consider first the case where the definition of "similar" product does not cover the whole quality spectrum. This amounts to assume that  $\Delta < 1$ . As previously, the free trade equilibrium involving a high quality foreign product is not affected. As for the alternative quality configuration, two cases are possible. First, for  $\Delta < 3/7$ , the free trade equilibrium involving ( $s^D = 1, s^F = 4/7$ ) is not affected either. To see this, consider the following: by choosing a quality level  $s^F = 4/7$ , the foreign firm is in no danger of "injuring" the domestic industry because products are sufficiently different in quality, i.e. they are not considered as similar ones. Domestic Welfare is therefore not affected in this case.

For  $\Delta \in ]3/7, 1[$ , the free trade equilibrium whereby the foreign firm sells the lower quality would induce a price-undertaking, since products would be viewed as similar. However, in this

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<sup>13</sup>S. Laird (1999) refers to price-undertakings as "Voluntary Export *Price Restraints*"

case, the foreign firm cannot credibly commit to the best available quality against *any* domestic quality choice. In particular, against a high  $s^D$ , the best response in quality by the foreign firm consists in choosing a quality level that lies "just below" the limit of what is considered to be "similar" by the European Antidumping authorities ( $s^F = 1 - \Delta$ ). We therefore obtain a second SPE exhibiting ( $s^D = 1, s^F = 1 - \Delta$ ). It is then a matter of computations to show that the corresponding domestic Welfare is a decreasing function of  $\Delta$ . This suggests that the European government would gain from adopting a restrictive view of "similarity". Or in other words, *the European government would be better off by exempting vertically differentiated goods from antidumping policies.*

As mentioned when describing the model, introducing a positive cost for quality would not affect the qualitative nature of our results. Indeed, the qualitative implication of proposition 1 is that the foreign firm will be more aggressive at the quality stage because of the A-D policy. Assuming that quality involves a sunk cost  $c(s_i)$  as is usually done in the literature.<sup>14</sup> will clearly not affect the foreign firm's incentives. More generally, the presence of a positive cost for quality is known to affect the *extent* of product differentiation (See Motta [1993]). By contrast, the argument underlying Proposition 1 rests exclusively on the *incentives* to differentiate, and more precisely on the necessity of relaxing price competition that is rooted in the demand side of the model. In any case, one of the firms must be the low quality one. Because of the antidumping legislation, the foreign firm is systematically "at risk" when choosing a lower quality. As a consequence, to choose a lower quality cannot be a valid equilibrium strategy for the foreigner, irrespective of costs. Still, introducing costs would allow us to take into account the possibility that domestic and foreign firms may not be equally efficient in producing quality. As argued by Herguera and Lutz [1998], two pure strategy equilibria in quality will exist as long as firms are not too different in the cost of providing quality. Of particular interest to us is the case where the foreign producer would be less efficient. An obvious possibility in this case is that the foreign firm cannot provide a high quality at a sufficiently low cost. The likely effect of the A-D policy is then to exclude the firm from the market since selling a low quality is not profitable because of the undertaking. As a protection policy, this is very effective but the resulting impact

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<sup>14</sup>See Lehmann-Grube (1997) for a general treatment of quality choices with sunk cost.

on Domestic Welfare is less clear because the domestic producer enjoys Monopoly power in the market.<sup>15</sup>

Introducing costs may also be helpful in explaining the following paradox: our results clearly suggest that AD policies may hurt domestic producers, so why do domestic firms lobby for it? In this respect, it is important to stress first that the kind of effects involved in our analysis are typically long-term ones, so that a possible explanation is to be found in firms being shortsighted. This explanation is clearly not entirely convincing although it is worth reminding that in the case of import quotas, domestic firms also were actively lobbying while the induced quality upgrading of imports ultimately hurt them. If, on the other hand domestic firms are quite confident that they benefit from a cost advantage in producing the high quality level, then they could lobby for AD policy, precisely in order to use it to deter foreign entry. In this respect, our results suggest that the threat of price-undertakings could in fact provide a strong incentive for foreign industries to improve their ability to produce high quality products before entering the European market.

Another limitation of our analysis is that we have confined ourselves to the case of price competition. In this respect, it is important to note that, under our zero cost for quality assumption, no product differentiation would prevail under Cournot competition and free trade. It is indeed easy to show that the unique SPE of a two-stage game with quality choice followed by quantity competition involves both firms choosing the best available quality.<sup>16</sup> In this case, the A-D legislation would not apply. Cournot competition yields product differentiation in equilibrium only if the cost for quality is strictly positive. If this cost is the same for both firms, there will exist two symmetric SPE exhibiting product differentiation. Again, a price-undertaking will affect quality choice only in the case where the foreigner sells the low quality product. Since the price-undertaking means that prices have to be equal, it will again be true that the foreign firms end up with zero demand. We are then led to conclude that, as under

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<sup>15</sup>In the presence of costs for quality, the leapfrogging issue also can be reconsidered. Obviously, the presence of costs asymmetry between domestic and foreign firms could induce other outcomes. For instance, if quality involves a large sunk cost, the threat of a price-undertaking could deter entry from foreigners whereas if it enjoys a cost advantage, it could leapfrog the domestic firm.

<sup>16</sup>See for instance Eaton and Harrald (1992) for a proof of this result.

price competition, the incentive to adopt a low quality profile is drastically weakened for the foreign firm.

Sofar, we have conducted the analysis assuming that the government will impose a price-undertaking. However, EU antidumping policy can also involve an antidumping duty on foreign imports. In principle, the purpose of the duty is the same as that of a price-undertaking, namely to eliminate the injury as measured by the extent of price undercutting in the absence of measures. Absorption of the duty by the foreign firm is outruled by law. Thus when the foreign firm does not fully pass through the duty to consumers, it will be subject to an additional penalty. A duty thus results into identical market prices. In our particular setting, this leaves a low quality firm with zero demand. Qualitatively, firms' incentives regarding quality choice are roughly equivalent to those prevailing with the price undertaking.

## 4 Conclusion

The purpose of this paper was twofold. First, we showed how price competition between a domestic and a foreign firm selling vertically differentiated goods on the European market is affected by European antidumping protection. We focused on the effects of price-undertakings on foreign imports. Second, we analyzed the long term effects of such trade policies on the qualities offered by the firms in the European market. Our findings suggest that when accounting for the effect on firms' quality choices in the long-run, whenever the antidumping policy affects the free trade outcome, it leads to an overall Welfare loss. The intuition for our result is easily summarized. While a price-undertaking protects the domestic firm in the short run by relaxing price competition, it allows the foreign firm to credibly commit to a high quality in the first stage of the game (precisely to avoid the price-undertaking in the second stage). The best reply of the domestic firm is then to produce the low quality variant. This is likely to be damaging for the Domestic Welfare because it increases profit diversion. While quality upgrading has already been established empirically for other trade instruments (quotas and VER), the argument put forward in this paper, namely that AD-policy can also lead to quality upgrading of imports, remains to be verified in further research.



## A Appendix: Price Competition under vertical differentiation

Consider a two-stage game with quality choice in the first stage. In the second stage, two firms sell indivisible goods differentiated by their quality index, respectively denoted by  $s^h$  and  $s^l$  with  $s^h > s^l$ . Consumers in the market buy at most one unit of the good and exhibit heterogeneous preferences. More precisely, they are identified by their "taste for quality",  $x$ , which is uniformly distributed in the interval  $[0, 1]$ . The net utility of consuming good  $i = \{h, l\}$  for a consumer with taste  $x$  is defined by the following equation:

$$u^i = x \cdot s^i - p^i \quad (A.1)$$

where  $p^i$  is the unit price of good  $i$ . The default utility of no-consumption is assumed to be zero. We assume that firms choose qualities at zero cost. The range of possible qualities is exogenously bounded between zero and 1, i.e.  $s^i \in [0, 1]$ .

We develop the construction of firms' best replies in the pricing game because they provide a very useful benchmark for the analysis of antidumping policies.

Observe first that for  $i \in \{l, h\}$ , the consumer located at  $x^i = p^i/s^i$  enjoys zero utility, hence, every consumer with taste  $x > x^i$  is willing to buy product  $i$  at price  $p^i$ . Potential markets are thus respectively  $[x^l, 1]$  and  $[x^h, 1]$ . The second step is to identify the marginal consumer  $\tilde{x}$  who is indifferent between the two products  $h$  and  $l$ . Solving for  $\tilde{x}s^l - p^l = \tilde{x}s^h - p^h$ , we obtain  $\tilde{x}(p^l, p^h) = \frac{p^h - p^l}{s^h - s^l}$ . Obviously, any consumer  $x > \tilde{x}$  prefers  $h$  to  $l$  whereas the contrary prevails for  $x < \tilde{x}$ . Observing that quality levels can be re-scaled, we may set  $s^h = 1$  so that demands are given by (A.2) and (A.3)

$$D^l(p^l, p^h) = \begin{cases} \tilde{x} - x^l & \text{if } p^l \leq p^h s^l \\ 0 & \text{if } p^l > p^h s^l \end{cases} \quad (A.2)$$

$$D^h(p^l, p^h) = \begin{cases} 1 - \tilde{x} & \text{if } p^l \leq p^h s^l \\ 1 - x^h & \text{if } p^l > p^h s^l \end{cases} \quad (A.3)$$

The particular shape of demands reflects the fact that in vertically differentiated industries, the high quality firm may exclude the low quality one from the market. The latter, in order to enjoy a positive market share must quote a price  $p^l$  significantly lower than  $p^h$  to compensate

for a lower quality ( $p^l < p^h s^l$ ). Note also that since  $x \in [0, 1]$ , the market cannot be covered in equilibrium, except perhaps for the case where  $s^l = 0$ .

The profit of the low quality firm is given by equation (A.4)

$$\pi^l(p^l, p^h) = p^l \left( \frac{p^h s^l - p^l s^h}{s^l(1-s^l)} \right) \quad (A.4)$$

The solution to  $\frac{\partial \pi^l}{\partial p^l} = 0$  is  $\psi^l(p^h) = \frac{p^h s^l}{2}$ . Since  $\psi^l(\cdot)$  always lies strictly in the region where firm  $l$  enjoys a positive market share, the low quality firm best reply is fully described by  $\phi^l$ .

As for the high quality firm, two regions are of interest. The monopoly region and the duopoly one. In the monopoly region ( $p^l > p^h s^l$ ), the best reply is the monopoly price  $1/2$  which is feasible if and only if  $p^l > s^l/2$ . Otherwise,  $\pi^h$  is strictly increasing in the monopoly region and we always reach the duopoly region, where the profit is given by equation (A.5)

$$\pi^l(p^l, p^h) = p^l \left( 1 - \frac{p^h - p^l}{1 - s^l} \right) \quad (A.5)$$

The solution to  $\frac{\partial \pi^h}{\partial p^h} = 0$  is  $\psi^h(p^l) = \frac{p^l + 1 - s^l}{2}$  and this is feasible whenever  $\psi^h(\cdot) \leq p^l/s^l \iff p^l \leq \frac{s^l(1-s^l)}{2-s^l}$ . Otherwise,  $\pi^h(\cdot, p^l)$  is strictly increasing in the duopoly region and the frontier price  $p^l/s^l$  is optimal. Since we have  $\frac{s^l(1-s^l)}{2-s^l} < \frac{s^l}{2}$ , the best reply of firm  $h$  is

$$\phi^h(p^l, p^h) = \begin{cases} \psi^h(p^l) & \text{if } p^l \leq \frac{s^l(1-s^l)}{2-s^l} \\ \frac{p^l}{s^l} & \text{if } \frac{s^l(1-s^l)}{2-s^l} \leq p^l \leq \frac{s^l}{2} \\ 1/2 & \text{if } p^l \geq \frac{s^l}{2} \end{cases} \quad (A.6)$$

Figure 1 depicts a standard configuration for free trade best replies, where  $\phi^h$  is drawn in plain bold and  $\phi^l$  in bold dashed. As one can see on figure 1, the free trade equilibrium is given by the intersection of  $\psi^h$  and  $\psi^l$ , i.e. in the region where both firms enjoy a positive market share, which in turn requires that the low quality firm names a price that is strictly lower than the high quality one.

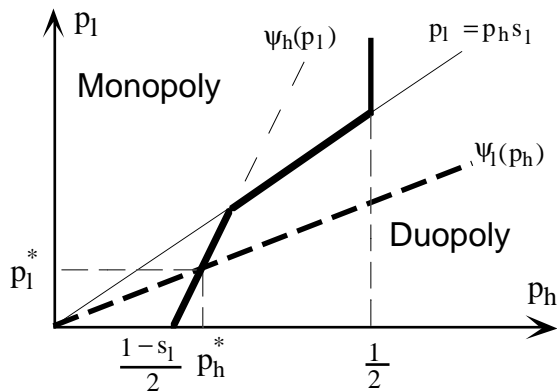


Figure 1

Using equations (A.4) and (A.6), it is a matter of computations to show that the unique Nash equilibrium is defined by equations (A.7) and (A.8)

$$p^{l*} = \frac{s^l(1-s^l)}{4-s^l} \quad (A.7)$$

$$p^{h*} = \frac{2(1-s^l)}{4-s^l} \quad (A.8)$$

Plugging these prices into (A.3) and (A.5), we obtain the reduced forms for payoffs at the quality stage as a function of the products' quality ranking. Straightforward computations then establish Lemma 1.

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