ANTITRUST IN NEW ZEALAND

The Case for Reform

NEW ZEALAND BUSINESS ROUNDTABLE

September 1988

Acknowledgements

This study was prepared for the New Zealand Business Roundtable by Susan Begg of Jarden Morgan New Zealand Limited. Benjamin Klein and Roy Kenney (University of California, Los Angeles) advised on the project and contributed specific sections. Frank Matthewson (University of Toronto) prepared the section on Canadian antitrust policy and Penelope Brook (office of the New Zealand Business Roundtable) participated in the study and wrote the section on the United Kingdom. The assistance of Bryce Wilkinson and Stephen Jennings of Jarden Morgan New Zealand Limited is also acknowledged.

CONTENTS

Overview and Summary of Proposals for Reform i

Chapter One : The Theoretical Framework

Section 1	Introduction	1
Section 2	Antitrust Policies : An Overview	3
Section 3	Private Arrangements for the Efficient Allocation of Resources	13
Section 4	Potential Problems with Private Arrangements	19
Section 5	Implications for Antitrust Policy	27
Section 6	The Economics of Law Design and Enforcement	43
Section 7	Empirical Evidence on the Costs of Monopoly and the Potential Costs of Intervention	54
Appendix I		61
Appendix II		63

Chapter Two : International Antitrust Experience

Section 1	Introduction	71
Section 2	The United States	72
Section 3	Canada	82
Section 4	The United Kingdom	87

Chapter Three : New Zealand Antitrust Policies

Section 1	Introduction	95
Section 2	Statutory Provisions	96
Section 3	The Interpretation of Key Principles by the Commerce Commission	99
Section 4	High Court Decisions	115
Section 5	Assessment of the Act in Terms of Economic Principles	121
Section 6	Conclusion	130

Chapter Four : Reform of the Commerce Act

Section 1	Introduction	133
Section 2	The Design of a New Act	136
Section 3	Conclusions	147

References 149

OVERVIEW AND SUMMARY OF PROPOSALS FOR REFORM

The Context of the Commerce Act Review

Economic activity should serve people's needs and promote their welfare. Scarce resources in the face of potentially unlimited needs make the efficiency with which resources are used crucially important. Information costs force decentralised approaches to coordinating economic activity so as to maximise the efficiency with which resources are used. In order to promote maximum efficiency, government policy must aim to harness the decentralised competitive market process in which firms and individuals are free to form contracts and to exchange resources, goods and services.

How well such a competitive process functions depends on the quality of the system of rules establishing and protecting ownership rights in resources and providing legal backing for contracts and market exchanges. These rules at once constrain activity and facilitate it, ideally setting limits on the actions of individuals in such a way as to enable them to cooperate to produce the goods and services which the community desires. Other rules may set limits on the distribution of income, according to socially accepted standards.

For example, the recognition and enforcement of private property rights in resources provides strong incentives for them to be used productively, and the existence and enforcement of a law condemning fraud encourages confidence in contracting and market exchanges. Similarly, the government may use its authority to impose taxes to make transfers to achieve social equity objectives, or to provide public goods. In designing regulations governments must aim to select those constraints which best enable a full set of social objectives to be met.

This study considers the appropriate regulation of market power, or, more precisely, the potential for market power to be abused to the detriment of consumers. Most simply, this may be seen as the potential for prices to be raised and output to be reduced in situations where a producer faces weak competition. The monopoly problem, whether caused by the natural characteristics of a market or by government regulation, and whether in markets for goods and services or markets for such productive inputs as capital and labour, has long concerned economists and governments. Antitrust laws, sometimes referred to as competition laws, have evolved in an attempt to meet these concerns.

Antitrust law is based on the idea that situations can arise in which producers could exploit consumers even where markets are open to competition. It has also been seen as a means of limiting the market power of producers who benefit from statutory protection. The latter has been particularly important in New Zealand, where over a long period the main monopoly concerns have stemmed from government interventions such as import licensing and occupational regulation.

Over recent years, there has been a fundamental reconsideration of how market regulation should be approached. In particular, the present government has comprehensively reviewed many policies bearing on economic efficiency.

Significant moves resulting from this review have included the removal of legislative barriers to entry for the production of goods and services; the clarification of price signals through the removal or reduction of specific incentives, subsidies, regulations and forms of import and export protection; moves to competitive neutrality between industries in bidding for resources (avoiding a government role in picking winners); the provision of a more stable and predictable general economic policy environment; a shift to dealing with welfare issues through general welfare policies rather than specific subsidies; and, of particular relevance

to the current study, the replacement of much industry-specific legislation with general trade practices legislation under the Commerce Act.

These policy changes have fundamentally altered the economic and commercial environment in New Zealand, and in this context there is a need to review the role and structure of our antitrust policy, in the form of the Commerce Act.

While the character of market power and the potential for its persistence have been changing, potential monopoly problems remain. It is important to develop the best possible policy both for assessing the case for intervention where monopoly power is observed, and for dealing with situations where monopoly power is exercised at the expense of consumers. In many cases, the best approach to dealing with outstanding monopoly problems (for example in the public sector and the labour market) will be to continue the process of exposing the relevant activities to greater competition. However, the Commerce Act may be seen as complementary to primary approaches of this sort, and may have a role to play in checking both the abuses of power that can occasionally occur in deregulated markets and those that are often present in markets which have not been fully exposed to competition.

The Case for Seeking an Optimal Antitrust Policy

The general policy changes outlined above are leading to the rapid internationalisation of the New Zealand economy, and resulting in major structural changes. This process of adjustment should not be seen merely as a transitional phase, although there is a considerable backlog of adjustment to be worked through. A changing international environment, as well as changing domestic needs and aspirations, require any flexible economy to be constantly adapting. Internationalisation must, of course, be seen in a far broader context than our relationship with Australia under CER, extending rather to the rapidly evolving markets of the Pacific Basin as well as to more distant markets. It follows that our antitrust policy should not seek harmonisation for its own sake with the policies of what are currently our closest trading partners. The concern should rather be to develop an antitrust policy which promotes economic efficiency and hence places New Zealand businesses in the best possible position to adapt to new domestic and international opportunities as they arise.

Before the major policy reforms of the 1980s, the potential (and pressure) for structural change in New Zealand was limited, and major reorganisations of companies were relatively infrequent. The range and potency of industry- and product-specific interventions meant that opportunities for the abuse of market power abounded, but the mechanisms used to deal with such abuse were usually the blunt ones of price (or wage or rent) controls. The increased frequency of mergers and takeovers has created a greater need on the part of regulators to understand the role of such processes in creating more efficient industrial structures. At the same time, there has been a need to reassess appropriate regulatory responses to the potential abuse of market power.

Events since 1984 have brought into focus the issues raised by antitrust policy in a more open economic environment. The present Commerce Act rules are such that restructuring has generated an increased workload for the Commerce Commission, giving it jurisdiction over a number of major company reorganisations. Considerable criticism has been expressed about the way in which the Commission has handled some of these cases. Irrespective of opinions as to the appropriateness of particular findings, it is apparent that many parties have incurred substantial costs in the course of these cases. There is a need to review the justifiability of imposing such costs, which include legal fees, distortions to efficient economic decisions, uncertainty and delays, and the broader costs of dissuading other companies from undertaking potentially desirable activities, setting them against the benefits of the current legislation as implemented.

The most visible cases brought since the 1986 Commerce Act have been those involving **mergers**. This reflects the radical restructuring required of many New Zealand firms to enable them to meet enhanced domestic and international competition. Unwarranted impediments to such adjustment will have a detrimental impact on the financial strength of such firms, and increase the risk to production and jobs posed by the more competitive environment. Not all adaptation of course involves a greater concentration of activity, and there has in practice been considerable decentralisation and small firm activity since the restructuring process began. However, where financial strength and the exploitation of scale economies are necessary attributes in the international economy, the survival of an industry may depend on a reduction in the number of units, even to a single firm. It is not clear that this raises any concern that a "monopoly" position will be abused where such firms are operating in the international market. In such cases, obstacles to mergers may lead to company failures or impose such costs and risks that ownership of New Zealand assets is transferred offshore.

Commercial practices also need to be reassessed in the light of the changing regulatory environment. Distribution and marketing arrangements, cooperative schemes and contracts between companies at different points in the production process are now subject to markedly greater competitive pressure. If they survive the test of competition, it is normally fair to assume that they are efficient and in the interests of consumers. Interventions rendering them illegal, or even illegal until proven beneficial, will, as in the case of an unduly restrictive merger policy, risk weakening the ability of New Zealand firms to meet external competition.

Indeed, the new environment has, if anything, increased the need for some forms of inter-firm cooperation. For example, in the meat industry the need to reduce capacity led to an important agreement between firms that enabled this process to be handled in an efficient way. Another field in which such cooperation is likely to become increasingly important is research and development, with collective research projects in many cases being the most efficient way of promoting innovation. It is important that such efficient and necessary activities should not be obstructed by inappropriate legal or bureaucratic constraints.

A new set of antitrust issues is now arising with the state-owned enterprises. Some sections of these enterprises have been regarded as having the characteristics of natural monopolies. While technological and regulatory changes have in some such cases cast doubt on their natural monopoly status, antitrust issues remain important both for SOE policy and for the privatisation process. These issues must be resolved so as to provide the best possible commercial environment for such enterprises, and the Commerce Act will clearly be a significant factor in this environment. Again, it will be important to avoid situations which give rise to economically-distorted buying and selling opportunities or artificial biases with regard to overseas ownership. Uncertainty about the implications of antitrust for the future of such enterprises could greatly reduce their sale value.

The Commerce Act Review

The present Commerce Act reflects a relatively limited reformulation of antitrust policy early in the regulatory reform process. It embodied some useful adjustments, such as the increased asset threshold for mergers, which had the potential for reducing the number of mergers potentially considered by the Commerce Commission.

However, some of the arguments motivating the changes were inconsistent with the rationale for many of the broader policy initiatives. For example, it was argued that stronger antitrust sanctions were required to ensure that "private" regulation of markets did not supplant "official" regulation, whereas in reality the scope for anti-competitive behaviour had been reduced, not enlarged, by other policy changes. Politically, some vehicle was thought to be needed for dealing with "special" problems cited by some industries (such as wheat and petroleum) then facing deregulation. At the time the Government also expressed the intention

that this policy area should be reassessed in the light of experience. This decision led to the current review.

The experience of the past two years has provided us with a good basis for considering the state of the law and its administration. Since 1986, many parties have become more aware of the significance of the policy and better informed about its implications. The Commerce Commission has been helpful in analysing and explaining the key concepts in the Act, with the result that its strengths and weaknesses have become clearer. Firms and their legal and economic advisers have also had the benefit of extensive involvement in cases brought under the Act.

The current review provides an opportunity to benefit from this accumulated experience, as well as to assess its implications for such approaching issues as the privatisation of major SOEs. The Government's undertaking that the review should be comprehensive is therefore welcome.

The discussion paper issued by the Department of Trade and Industry raises many pertinent issues, but there is a need for some of them to be explored in greater scope and depth. The importance of developing a policy that will enhance rather than frustrate the benefits from a less regulated economic environment means that neither the scope nor the timetable of the review should be so constrained as to inhibit thorough analysis. It is also essential that the review process should be open and consultative, both so that all the relevant issues in this particularly difficult area of policy can be studied thoroughly, and so that the basis of the Government's eventual policy decisions are well understood by those who must conform with the Act. Transparency and rigour in the review process itself will contribute to greater commercial certainty.

For these reasons, the Business Roundtable recommends that a consultative review process be followed, of the kind used, for example, to develop tariff and tax reforms. The review should be conducted by a broad expert group, charged with evaluating submissions and preparing a report.

There may be a case for inviting comment on the Government's response to such a report before proceeding with legislation. By such a process, it could be assured that the complex technical issues involved will have been explored thoroughly before the issue goes to a Select Committee, thus assisting the parliamentary process.

Current Antitrust Thought and Practice

(These issues are discussed in Chapters One and Two of the study.)

Antitrust law is largely an American invention, founded on the Sherman Act of 1890 which declared illegal contracts, combinations and conspiracies to restrain trade, and provided checks on monopolisation. It was left to the courts to distinguish between permissible and impermissible collective actions, and from this grew an important body of case law. Subsequent legislation has essentially elaborated on the Sherman Act's basic principles. Canada adopted an anti-combine law in 1889, which underwent its first major revision in 1986.

In other countries, antitrust policies were adopted relatively late. The United Kingdom, for example, first enacted monopolies legislation in 1948, and then more on the basis of macroeconomic concerns with employment, international competitiveness and price stability than out of a concern with the abuse of monopoly power itself. While New Zealand had some monopolies legislation as early as 1908, the development of generalised antitrust law followed developments in the United Kingdom, with the passage of the Trade Practices Act in 1958. Japan and a number of other Asian economies have not developed extensive antitrust regulations.

The influence of economic analysis on the structure and implementation of antitrust policy has also varied between countries. Again, the United States led the way with the greatest concentration of academics researching in this area. The first major contribution of academic economists to antitrust analysis occurred with the development of oligopoly theories in the 1950s and 1960s.

These theories, which sought to explain the operation of markets characterised by only a few firms, were later largely discredited both empirically and theoretically, but their influence survived in the form of a heavily numerical approach to antitrust enforcement, in which decisions were based primarily on assessment of market shares and concentration ratios. In the United States, this approach was elaborated in the Department of Justice's 1968 Merger Guidelines. In a paradigm which postulated a causal flow from market structure to commercial conduct and performance, the resulting unfortunate inattention to such factors as potential competition and barriers to entry was unsurprising.

In the 1970s, apparently unprecedented interaction between legal and economic scholars, particularly at the University of Chicago, led to a greater emphasis on the economic factors underlying business conduct and industrial organisation. In the United States, the impact of the resulting academic "revolution" on the way in which antitrust was implemented was reinforced by the increasing internationalisation of the American economy, and growing economic literacy among Supreme Court judges.

The revised Merger Guidelines issued in 1982 reflected these changes, de-emphasising the numerical merger standards and recognising far broader sources of competition (focusing explicitly on entry barriers and competition from imports). A further revision of the Guidelines in 1984 increased the emphasis of antitrust policy on the efficiency of contractual arrangements and business practices.

This trend was less evident outside the United States, either in academic circles or in the revision and implementation of antitrust policy. In the United Kingdom, for example, policy remains focused on competition *per se*, consideration of entry conditions is relatively rare, and there appears to be little consistent attempt to assess the trade-offs between the "anti-competitive" effects of increased market concentration and the cost savings available from the exploitation of economies of scale or scope. A broadly defined "public benefit" test remains (leading to evaluation of mergers on the basis of their regional employment effects, for example), although this may be abandoned under proposed changes to restrictive practices legislation. In Canada, the most recent policy changes have moved practice closer to that in the United States. The approach to trade practices remains relatively restrictive.

No complete consensus has emerged among antitrust theorists as to the appropriate concerns of antitrust policies. At least in the United States, there is general agreement that vertical arrangements yield little cause for concern where they do not have a horizontal impact, but this is not matched, for example, by agreement on the impact of horizontal arrangements. However, a number of developments afford useful guidance for the design of policy.

Improvements in our understanding of the way in which economic activity is affected by the manner in which property rights are defined and enforced, of the impact of incomplete information and the costliness of contracting on the way in which activities are organised, and of the way in which these same factors affect the potency and results of government interventions, all have significant implications for the assessment of merger activity and purportedly "anti-competitive" practices.

These new insights focus our attention on the efficiency effects of activities rather than their impact on market concentration. They help to reveal diverse manifestations and sources of competition for the dollars of consumers. They provide insights into the way in which practices such as exclusive dealing, product tying and geographic arrangements can reduce transaction costs and lead to increased competition between products, and how activities such

as advertising, by improving information and building product reputations, can make consumers better, rather than worse, off.

Such insights have important implications both for the activities that should be brought within the jurisdiction of antitrust policy, and for the structure and application of that policy. For example, they suggest the inappropriateness of making any activity *per se* illegal, and the appropriateness of a case-by-case approach in assessing and responding to evidence of market power. They give clear indications as to the conditions under which mergers and practices should be automatically authorised by an antitrust authority. They also indicate the breadth of issues that must be taken into account in deciding whether market power exists which could be exploited at the expense of consumers (and confirm that such power is far rarer than was suggested by traditional oligopoly theory).

The property rights and transaction cost literatures also provide important insights on the costliness of government intervention, both directly and through its impact on incentives. This focuses attention on the design of antitrust policy so as to minimise uncertainty and delays, on the accountability of the antitrust authority, and on the costs and benefits associated with the tools available to it. They raise doubt as to whether the best feasible antitrust policy will in practice yield benefits in excess of its costs. They also help to identify the high real costs of the present Commerce Act.

The Commerce Act 1986 and its Administration

(These issues are discussed in Chapter Three of the study.)

The Commerce Act 1986 is concerned with two main areas of business activity, **trade practices** which are deemed restrictive, and **mergers and takeovers**. The central provisions of the Act give legal substance to a series of underlying economic concepts. The nature of these concepts, and the way in which the Act has been interpreted and applied, have a potentially large influence on the way in which business activity is organised and adapts to change.

The manner in which the Act is worded itself creates a number of problems, which have in some cases been compounded by the way in which the principles underlying the legislation have been interpreted in practice. These include a lack of clarity as to the Act's **objectives**, difficulties over the **interpretation** of its key concepts of dominance, substantial lessening of competition and public benefit, and the potential for **asymmetry in the treatment** of mergers and trade practices. Further, the Act contains some *per se* prohibitions which advances in economic analysis suggest to be inappropriate. Finally, the procedures of the Act have proved **cumbersome and costly**, and have involved unacceptable delays.

With regard to the **objectives** of the legislation, the Commerce Commission has in some cases argued for the Act to be concerned with the promotion of competition, and in others with economic efficiency, noting that competition is valued as a means of promoting efficiency, rather than representing an end in itself. The latter is the appropriate emphasis, and the purposes of the Act would arguably be better served if it were specified directly.

The Commission has also treated the distribution of efficiency gains in its application of the public benefit test in ways that many academic authorities would regard as inappropriate, differentiating "public" from "purely private" interest and weighting benefits according to the extent to which they are passed on to consumers. However, a recent decision more in line with current thinking explicitly rejected a distributive role for the Commerce Act.

The concepts of dominance and substantial lessening of competition are intended as mechanisms for determining whether a merger or practice creates a position which could be abused. The Commission has interpreted these terms so as to equate "dominance" with market power, and "substantial lessening of competition" with the substantial strengthening of market power. "Substantial lessening of competition" has been determined to involve a lower

competition threshold than "dominance", implying **asymmetric** treatment between mergers and other contractual arrangements.

In practice, the Commission's record in assessing dominance or market power reveals a number of inconsistencies. In relatively minor cases, the Commission has adopted a fairly permissive interpretation of dominance, emphasising the disciplining role of potential competition, including from imports. In some of the major takeover and merger cases its approach has been more restrictive, and appears to have involved a number of departures from its own basic principles, as well as flawed analysis. These include a narrowly focused concern with market structure; incorrect analysis of excess capacity; incorrect analysis of vertical integration; unfounded concerns regarding predatory pricing and cross-subsidisation; insufficient attention to competition from imports; and incorrect market definition. These flaws have had major implications both for the appropriateness of individual decisions, and for consistency between decisions.

The Commission's **interpretation of public benefit** has also been broad, with little consistency between cases either with regard to admissible benefits or with regard to attention to the distribution of these benefits. Benefits accepted include economic efficiency; enhanced international competitiveness; the rationalisation of excess capacity; enhanced consumer choice and employment opportunities; savings in overheads; technical and marketing economies; improved public safety; utilisation of New Zealand resources; and enhanced regional employment prospects. While the majority of these are consistent with the broader objective of maximising economic efficiency, in several instances the Act has been used to address issues which we consider extend beyond its appropriate concern. The Commission has faced conceptual and practical problems in balancing any detriment to competition against the public benefits expected to accrue from a merger or practice. Given the manner in which the Commission has interpreted and applied these concepts, its analysis has tended to be biased (from an efficiency perspective) towards excessive intervention. The role of the Act in this regard could be clarified by the specification of an efficiency objective, and the removal of a separate "public benefit" test.

Similar problems have arisen in the interpretation and application of the Act by the High Court. Further, there has been little consistency between the principles and analyses adopted by the Commerce Commission and those adopted by the Court. Although in both cases there have been some analyses of a high quality, a number of the principles adopted have diverged in important ways from widely accepted economic thought.

From this economic perspective, the major weaknesses in both Commission and Court decisions stem from a failure to recognise economic efficiency as the objective underlying, but not specified in, the Act, or to interpret competition as a means to efficiency (and hence consumer welfare) rather than as an end in itself. The objectives pursued under the Act have been further confused by the Commission's wide-ranging interpretation of public benefit.

Overall, these weaknesses have given rise to a bias towards intervention, imposing significant economic costs which might be avoided under better designed antitrust rules.

Proposals for Reform

(These issues are discussed in Chapter Four of the study.)

Even in an economy open to international markets and relatively free of regulations that confer benefits on some sectors at the expense of others, market power may be accumulated and exploited at the expense of consumers. The Government needs to seek the most efficient means for dealing with potential monopoly problems.

To this end the Government needs to continue its reassessment of such statutory monopolies as producer boards, occupational cartels and organisations such as the Accident Compensation Corporation, and of legislation such as the Labour Relations Act, which confers exploitable market power on some unions. While cooperative marketing arrangements, occupational bodies with binding membership criteria, or unions engaging in collective bargaining may all enhance the efficiency of economic activity, it is also possible that such organisations will achieve monopoly power. Whether or not such power is protected by statute, a well-constructed antitrust policy may be an optimal check on its abuse.

The extensive deregulation of New Zealand's product markets has greatly reduced the extent of concerns about widespread monopoly power in many industries, especially those exposed to international competition. The concern is rather that inappropriate design or implementation of antitrust law could both obstruct efficient adjustment and be exploited so as to perpetuate, rather than break down, inefficient practices that have survived because of positions of privilege. There is a very real risk that antitrust policy could yield more harm than good, whether by condoning harmful practices or by obstructing or discouraging potentially beneficial ones. In its review of the current Commerce Act, the Government must satisfy itself that a well-designed law, with a well-structured administrative apparatus and competent administrators, could feasibly overcome these risks, and yield some overall benefit.

If this test can be met, our analysis suggests that an ideal law might have the following characteristics:

* the objective of the Act should be clearly stated, as a guide both to its administrators and to businesses and their customers. **The objective should be stated in terms of economic efficiency** (the efficient use of economic resources through market processes being central to the welfare of all citizens as consumers);

* the Act should be **uniform in its treatment of contracts (mergers and takeovers) and practices**, both vertical and horizontal;

* **no practices should be *per se* illegal;**

* the registration of mergers, takeovers and practices with the Act's administrative body should be **voluntary** in all cases. There should be scope for injunctions to halt unnotified proposals and enable them to be examined, and for *ex post* remedies if a position of market power is acquired and exploited;

* there should be a **prompt, transparent and predictable** mechanism by which all contracts and practices that give no cause for concern are authorised. To this end, the use of a set of filters is recommended. Only practices and contracts failing **all** filters should receive further attention. In applying the filters, the onus of proof would fall on the regulatory body. Suggested filters would involve assessment of:

(1) whether the good or service involved is **currently imported;**

(2) whether the good or service involved is **exported** and/or **potentially importable,** and transport costs are relatively low;

(3) whether the relevant market involves a number of **alternative suppliers or products;**

(4) whether **barriers to entry** imposed either by sunk costs or by legislation are **relatively low,** and

(5) whether barriers prevent monopolists or alternative suppliers and customers from reaching some **negotiated solution** to monopoly problems (where the number of customers is relatively small).

There would be a time limit of no more than 20 days for the application of such filters;

- where all of the above filters were failed, contracts or practices would be subjected to further analysis (within an overall maximum of, say, 60 days), and would be permitted where the resulting efficiency gains were found to exceed the potential detriment to consumers. At this stage, the onus of proof would be on the parties to the contract or the promoters of the practice;

- monetary penalties should be available in the case of infringements of the Act. Costs should be allocated so as to dissuade frivolous actions. The body applying the legislation should also have the power to make recommendations to the Government on any further regulatory response in individual cases.

There is a strong case for brevity and conciseness in the Act itself. (It is noteworthy that the substantive provisions of the Sherman Act, on which American antitrust policy is based, run to little over 70 words, while the European Community legislation is based on two relatively concise Articles in the Treaty of Rome.)

The process by which the Act is administered should reflect its central concern with the protection of consumer interests. It should thus provide for action by consumers or by their agents. In the case of court action this may require provision for class actions and for contingent fees.

While the identity of the body accepting registration of contracts and practices and administering the suggested filters is, given its accountability and the quality of its officers, of no great significance, the administrative framework by which arrangements failing the filters are adjudicated is of considerable importance for the quality of results. There are a number of requirements here, relating both to personnel and to procedures. However well-framed in terms of its statement of intent and guidance to procedures, the quality of decisions taken under the Act will depend on the experience and skills of those implementing it. This points to an initial requirement to structure recruitment policy, remuneration and conditions of employment so as to attract the best possible administrators.

A second requirement is that the administrative process should be as open as befits the confidentiality of the information required for decisions to be reached, should be readily monitored, and should ultimately be accountable to the government. There should be some explicit mechanism for auditing decisions. Further, administrators should face clear incentives, for example through the allocation of costs, to investigate beyond the initial stages only those practices and arrangements where there is a strong expectation that consumer welfare is endangered.

Thirdly, the time involved in reaching decisions on cases failing the filters should be minimised (subject to the proviso that this should not be at the expense of ascertaining the merits of the case).

On balance, there is no clear case for regarding either a Commission or the Courts as the preferred body for administering the Act, or indeed for preferring a combination of the two. The suggested filters could equally be applied by Department of Justice, Ministry of Commerce or Commerce Commission staff appropriately qualified in law and economics. Expertise in adjudication of cases proceeding beyond such filters might be accumulated equally by Commissioners and by Court Judges. Both mechanisms have shortcomings in terms of the

incentives to gather and appropriately interpret all relevant evidence, the time required to reach decisions, and accountability in deciding and imposing penalties and remedies. The relative merits of the alternative approaches require further analysis.

Finally, we recommend that provision be made for the revised legislation to be reassessed in the light of experience, either through the stipulation of a review date, or through sunset clauses in the Act itself.

CHAPTER ONE : THE THEORETICAL FRAMEWORK

Section 1 Introduction

Economic scarcity arises from apparently unlimited human demands made in relation to limited available resources. Consequently every society must adopt laws and regulations that, together with social mores, constrain individual actions to ration available resources amongst individuals.

How well a society performs in meeting the needs and aspirations of its members will depend greatly on the quality of the constraints it adopts. From an economic perspective, good quality arrangements will reward individuals who succeed in finding new and innovative ways of satisfying human needs at least cost.

In considering changes to existing institutional arrangements such as the Commerce Act, governments must be concerned to evaluate carefully the effect of the proposed changes on the incentives individuals face and on the costs they impose on individuals as they respond to these changed incentives.

Section 2 of Chapter One explains the basis for current antitrust policies and develops the concept of economic efficiency as the key criterion for evaluating the desirability of changes to existing rules. Equity and other objectives can be achieved more directly and at a lower cost through other government policies such as those that operate through the tax and transfer systems.

Section 3 discusses the private arrangements that develop to minimise the cost of producing output given the property rights framework established by the government. Most business arrangements enhance the efficiency with which resources are used. The section describes why private arrangements may be complex and why firms may merge or enter into non-standard contracts. It notes that private individuals face strong incentives to maximise the opportunities for welfare-enhancing transactions. Nevertheless, the possibility remains that the existing definition of rights does not maximise efficiency.

Section 4 discusses situations where rights defined by the government may not maximise efficiency. It notes some of the situations in which private arrangements, within a general framework of well-defined property rights, may not exhaust all of the efficiency-enhancing transactions that are possible. It notes that potential problems will arise in a limited number of situations. For problems to arise there must be no similar alternative suppliers of the product concerned and no reasonably similar alternative substitute products that would meet consumers' needs at a similar cost; barriers to entry into a market must be high, either because of inappropriately scaled legal barriers to entry or sunk costs; goods must be non-traded or, if traded, be subject in New Zealand to high transport and/or prohibitive tariff barriers; and there must be barriers to incumbent firms negotiating with consumers to increase output.

Section 5 discusses the implications of the analysis of problems with private arrangements for antitrust intervention. It discusses why mergers, collusion and strategic behaviour may give rise to policy concerns. It examines how the government may cope with firms that have already established "market power".

Section 6 considers issues relating to the design and enforcement of the antitrust laws.

Section 7 examines the evidence on the potential costs of "monopoly" and the costs of intervention. It concludes that the costs of monopoly in deregulated markets for goods and

services are likely to be modest. On the other hand, it is clear that significant costs are associated with antitrust intervention.

Appendix I to Chapter One presents the traditional analysis of the monopoly problem.

Appendix II observes that the system of property rights that defines the terms on which individuals have access to resources is an essential element in the achievement of an efficient allocation of resources. It concludes that the cornerstone role for government antitrust policy is defining and enforcing such rights.

Section 2 Antitrust Policies: An Overview

This section summarises the conventional rationale for antitrust policies, briefly defines the nature of such policies and discusses the competing criteria for evaluating them. It concludes that economic efficiency should be the objective of antitrust policy. Antitrust policy should be used to ensure that transactions between people allow the maximum mutual benefit to be derived from scarce resources.

2.1 Rationale for Antitrust Policy

2.1.1 *Arrangements that Maximise Welfare*

Because resources are scarce relative to the demands made on them, society must adopt arrangements that:

- regulate access to resources; and
- provide incentives for resources to be put to their most valued uses.

People improve their welfare by specialising in production and then trading to obtain the resources they value most highly. The improvements from this process we term "gains from trade or exchange". Governments may be able to affect the costs of trading and therefore the potential gains from trade through the design of the property (and contractual) rights system. In general, the government will aim to define property rights so as to minimise the transaction costs of undertaking mutually beneficial exchanges. The rules should ensure that individuals find it most profitable to provide, as cheaply as possible, outputs which others value most highly in relation to the costs of production.

The adoption of antitrust policy stems from a belief that people, operating within the general laws and regulations, will not always produce the best attainable production pattern, level of output, or distribution of the gains from trade between producers and consumers. Antitrust proponents suggest that producers or factors of production pursuing their self-interest may derive undue profits at the expense of consumers (e.g. by restricting supply). In particular, monopolies and trade practices might have an adverse impact on consumer interests. The process of "competition" on the other hand, by means of enhancing efficiency, is believed to maximise consumer (and society's) welfare.

Antitrust policies stem from a desire to "make the market work better". They form part of the constraints within which transactions take place. Antitrust policies work by modifying the property rights of resource owners and therefore the incentives to undertake particular actions. The importance of property rights in shaping economic outcomes is discussed more fully in Appendix II.

On average, overall welfare will be maximised when output is produced to the point at which consumers are just prepared to pay a price which covers the cost of producing the last unit of output. This point is sometimes called the "competitive" level of output and price (see the diagram in Appendix I).

2.1.2 *Monopoly Concerns*

The monopoly problem arises because, in certain circumstances, firms can increase their share of the gains from exchange at the expense of overall gains. A monopoly firm may maximise profits by restricting output and raising its price as compared with the "competitive" level of output. The increase in a firm's share of the gains from trade may be obtained by colluding or merging to form a monopoly.

At the output level chosen by the monopolist, consumers would be prepared to pay more than the marginal cost of producing the output. The increase in price and restriction in output associated with a monopoly may result in consumers purchasing substitute products that are more costly to produce or less satisfactory than the monopolist's product. The additional cost for a given level of consumer satisfaction is said to involve a loss of **allocative efficiency**, sometimes described as the "welfare loss triangle"[1] (see Appendix I). Firms in this situation are sometimes said to have "market power".

The existence of monopoly pricing signals that potentially beneficial transactions are being forgone. In the monopoly situation, it would be in the joint interests of consumers and the monopolist to contract for an increase in output (if such a contract could be executed at a cost lower than the potential gains from further trades). The maximum potential gain in welfare to the parties concerned is given by the welfare loss triangle, the division of which could be the subject of negotiation. If, for example, the monopolist were able to price discriminate perfectly, it would be able to increase output (and profits) thereby reducing the efficiency loss. Price discrimination will improve allocative efficiency if the monopolist can charge each customer a price equal to the marginal cost for the last unit supplied, and whatever the individual consumer demand curve permits for all infra-marginal units.

However, the existence of transaction costs means that, in some circumstances, a monopolist will incur costs in identifying consumers who would buy if the price were lower, or in setting different prices corresponding to a consumer's demand schedule. Contracts designed to prevent consumers on-selling goods cannot be written costlessly. As a consequence, the monopolist is unable to effectively price discriminate and a hypothetical "deadweight loss triangle" can be derived in comparison to the competitive alternative.

The insight here is that the "monopoly problem" exists because of transaction costs. The problem arises because it is too costly to negotiate contracts with consumers to increase output. The parties cannot contract around the fact that as the supplier increases output it loses revenue on infra-marginal units. If this cost could be reduced, the monopoly distortion would be correspondingly reduced.

Whether or not the "loss" associated with monopoly is relevant in terms of economic policy depends on whether or not an alternative achievable arrangement can be identified that would lead to a better outcome. If analysis is to have any value for policy, the comparisons must be between attainable alternatives. Little is gained by observing that the real world is "imperfect" or noting that it would be improved if the costs of undertaking transactions did not exist.

Other costs are ascribed to monopoly. Instead of restricting output the firm may deliver a lower quality of output or slower service than that desired by consumers. It may produce a more restricted product range.

The higher price charged to consumers results in a transfer of income from consumers to producers (the so-called "monopoly rent"). Although the monopoly rent may merely be a transfer from consumers to producers without an overall loss to society, Posner[2] has pointed out that the presence of these potential profits may attract real resources into efforts by sellers to monopolise. This is generally a significant concern only where there are legalised barriers to entry.[3]

---

1 Posner, (1976), p 10.

2 ibid, p 11.

3 See for example Fisher, (1985).

The monopoly rents may be wasted through reduced pressure on management to produce output at the lowest possible cost, although the threat of takeover will constrain this behaviour. Some of the rents may be transformed into perquisites for management and workers. Workers will expend resources in attempting to gain for themselves a share of the profits. These concerns will arise particularly when a monopoly is publicly owned and capital market constraints on management are relatively weak.

Traditionally monopoly situations are thought to arise in the context of:

- legally-sanctioned barriers to rivals entering a market;
- increasing returns to scale which may give a large incumbent a unit cost advantage over a smaller competitor;
- large entry barriers arising from large sunk costs incurred by incumbents which would have to be largely duplicated by new entrants;
- collusive behaviour, by which incumbents act collectively to increase their "market power";
- predatory pricing in which a large organisation can sustain the losses necessary to drive a smaller competitor out of business or prevent successful entry into a market with a view to recovering those losses by achieving monopoly profits in that market subsequently;
- contractual arrangements which restrict the ability of competitors to obtain access to resources (e.g. exclusive dealing contracts), or
- mergers and acquisitions which tend to increase the "market power" of incumbents.

We shall see below that empirical work, combined with recent theoretical insights, has raised major questions about the practical validity of many of these concerns and about the efficacy of "corrective" antitrust policies. Nevertheless, the original focus of antitrust policy on the potential problems created by monopoly remains the focus of antitrust policy today.

2.1.3 *Competition*

"Competition" has been viewed in contrast with monopoly as a process which can act to align the interests of individuals with the overall interests of society. Adam Smith observed in 1776 that people separately pursuing their own interests can frequently achieve society's objectives at the same time in an orderly and efficient way.

However, some confusion has arisen in interpreting what people mean when they talk of using antitrust policy (or competition policy) to "introduce", "protect" or "promote" competition.

Competition refers to the struggle by people for a greater share of scarce resources within the constraints established by the environment within which they live. Leffler notes:

> "In its most fundamental sense, competition is ubiquitous to all economic systems. All forms of striving to enhance one's situation are competition. Indeed, there is competition wherever there is self-interest and scarcity. In this broad sense, neither government nor business policies affect the presence of competition, for neither self-interest nor scarcity is eliminated. The forms that competition take are, however, innumerable. The laws and rules of business conduct cannot increase or decrease competition, but they can and do alter the forms in which competition occurs." (1985, p 384)

From this perspective, it is not meaningful to talk of the notion of "introducing competition" because competition between individuals for scarce resources is inevitable and ever present. The way in which competition manifests itself will differ according to the constraints imposed. Some constraints and systems of property rights will result in inferior outcomes (in terms of a benchmark) to others.

The role of the government in this process is to establish the set of constraints that will ensure that individuals pursuing their own goals will simultaneously achieve the goals of society. The government achieves this through establishing the system of property rights, including economic regulations, which best direct the actions of individuals towards enhancing the wider community interest.

When people refer to the "process of competition" that should be "protected", they generally have in mind the process whereby the pursuit of self-interest results in the best possible outcome from the point of view of society. Bork defines competition as that process which leads to the maximisation of consumer welfare[4]:

> "'Competition' may be read as a shorthand expression, a term of art, designating any state of affairs in which consumer welfare cannot be increased by moving to an alternative state of affairs through judicial decree. Conversely, 'monopoly' and 'restraint of trade' would be terms of art for situations in which consumer welfare could be so improved, and 'to monopolize' or engage in 'unfair competition' would be to use practices inimical to consumer welfare." (1978, p 61)

"Competition" is sometimes interpreted in terms of a theoretical economic model. The model assumes that many suppliers of a homogeneous product exist in a market, each of whom is unable to affect the price at which output is sold (i.e. they are "price takers"). A firm would find no buyers if it charged above the market price and would gain all its competitors' business if it priced below the market. When rival sellers of a product are so small that they cannot individually influence market prices, competition between them will allow consumers to obtain the product at the "competitive" level identified in the diagram in Appendix I.

The strength of the simple competition model is its ability to explain how the price system functions to coordinate activity and direct resources to their most efficient use. Demsetz makes the important point that:

> "... it is the price system the model explicates, not competitive activity. Competitive *activity* itself is difficult to comprehend through a model that assumes away transaction and information costs." (1983, p 47)

However, the simple competition model abstracts from many important practical constraints. As Demsetz notes, it ignores information and transaction costs and it assumes homogeneous products are produced. It also assumes (at least implicitly) that exclusive property rights can be defined (e.g. by governments) for all resources and that beyond that governments do not exist. In reality, products are differentiated, taxes ensure that prices generally do not equal marginal cost, and the political and regulatory environment provides important constraints on economic activity. Alternative institutional arrangements confront decision makers with different constraints and therefore alter economic outcomes. The simple competition model cannot explain the variety of competitive strategies that are adopted in the real world. It

---

4 Bork equates the maximisation of consumer welfare to the maximisation of wealth :

> "Consumer welfare is greatest when society's economic resources are allocated so that consumers are able to satisfy their wants as fully as technological constraints permit. Consumer welfare, in this sense, is merely another term for the wealth of the nation." (1978, p 90)

provides no explanation for the existence of firms or of complex contracting arrangements which arise to minimise transaction costs.

The use of a simple competition model has led people to suggest that the objective of antitrust should be the "promotion of competition" where competition is variously interpreted to mean maximum rivalry or, alternatively, the state of the market assumed in the simple competition model. These views of competition ignore the fact that large benefits may accrue from the elimination of rivalry through the integration of decision-making into firms and the coordination of productive effort. Bork makes the following comment:

> "Our society is founded upon the elimination of rivalry, since that is necessary to every integration of productive economic efforts and to the specialization of effort. No firm, no partnership, no corporation, no economic unit containing more than a single person could exist without the elimination of some kinds of rivalry between persons." (1978, p 58)

In a similar vein Easterbrook observes that:

> "[p]art of the difficulty in antitrust comes from ambiguity in what we mean by competition. Antitrust aims at preserving competition as an instrument for creating economic efficiency. Yet... competition cannot be defined as the state of maximum rivalry, for that is a formula for disintegration." (1984, p 13)

The interpretation of "protecting competition" as preventing the elimination of rivalry later led the US Supreme Court to prevent practices which might have "lessened competition" and eventually led to monopoly. This doctrine resulted in the banning of mergers and agreements that would reduce the number of rivals long before the firms in question could have had any ability to raise prices and restrict output and harm consumers.[5]

2.1.4 *Differentiated Sellers*

In reality, most firms in the economy attempt to establish a market niche for their own skills and attributes. Products are differentiated and new products and processes cannot be copied costlessly or immediately because of information costs. Because information on product quality is costly to obtain, a reputation for fair dealing and a predictable quality of output will be valued by consumers. In the presence of information costs, investment in reputation or advertising will save on search costs for risk averse consumers. Firms may be unique because of their locations or because of the combination of people in the organisation.

These considerations mean that virtually no suppliers would lose all their customers if they raised their prices a little (that is, like the monopolist, they face a downward sloping demand curve).[6] They are therefore in the situation described by the diagram in Appendix 1. They can set their prices above the marginal cost of production, at least in the short run. We refer to firms in this situation as "differentiated sellers". These firms are unique in some way because of information costs and the differentiated products they produce. The suppliers of such products will always tend to sell at a level of output at which price exceeds marginal cost because this action will maximise their profits. These firms recognise that price will rise if less output is supplied; if the increase in price plus the reduction in the cost of producing output is greater than the loss from reduced sales, these differentiated sellers will have an incentive to restrict output. Demsetz notes:

---

5 Bork, (1978), p 47-48.

6 As Alchian and Allen note, "[t]he corner grocer, filling station owner, druggist, clothier, restaurant owner, and General Motors - all face a demand schedule such that they could raise their price per unit of a good without losing all their customers." (Alchian and Allen, 1983, p 237)

> "Information and transaction costs often make firms unique in time, place, and capabilities. Difficult to imitate, distinctive bundles of goods and services are offered to consumers by different firms in the 'same' industry... in the partial equilibrium of a given interval of real time, there can be no doubt that price setting capabilities are possessed by many firms. The quantities sold by firms do not fall to zero should they raise prices slightly." (1983, p 42-43)

In many circumstances, the ability to price above marginal cost will not reduce welfare when dynamic considerations are taken into account. Littlechild observes that an entrepreneur who discovers a new product before the rest of the market realises its potential may be able to charge a higher price while still the sole seller, but points out that this is not necessarily a problem:

> "It is true that he is restricting output compared to what he could produce, or compared to what would be produced if all his rivals shared his own insight. But they do *not* share his insight; this is not the relevant alternative. For the time being *the relevant alternative to his action is no product at all.* It would therefore be inappropriate to characterise his action as generating a social loss given by the welfare triangle... On the contrary, *his action generates a social gain given by his own entrepreneurial profit ... plus the consumer surplus.*" (emphasis in the original, 1981, p 358)

An assumption that there is always a problem when price exceeds marginal cost risks committing the "free lunch" fallacy. For example, the development of a firm's reputation may result in the price being above marginal cost. However, a reputation for predictable quality allows consumers to economise on information and search costs. This is a dimension of the product's output that is valued by customers. Production of reputation will be undertaken because the marginal cost of the investment is less than the marginal benefit received.

The apparent restriction of output associated with differentiated sellers may signal a situation in which beneficial transactions are not being undertaken. However, other more valuable transactions may be facilitated. There is a problem only if an alternative feasible arrangement can be identified that would improve on the result. There is no loss and therefore no problem if a superior alternative cannot be identified. As Alchian and Allen explain:

> "That underproduction ... would be a genuine waste only if there were an economically worthwhile way to avoid it. If it were the result of a legal monopoly, presumably a change of the law could repeal the monopoly... Often, even where there is no protected monopoly, information costs, transaction costs, and economies of scale may be involved. Because no economically efficient alternatives to these are known, the underproduction is not a waste or inefficiency; like wintry cold, it is economically unavoidable." (1983, p 256)

2.2 Objectives of Antitrust Policies

Different people suggest a variety of objectives for antitrust policy. These include:

- ensuring that prices more accurately reflect marginal cost and output is not restricted (i.e. enhancing allocative efficiency) and that output is produced at lowest cost (i.e. maximising productive efficiency);

- influencing the distribution of income;

- promotion of smaller competitors;

- promotion of "competition" as an end in itself, although it is not always clear what is understood by "competition". The suggestion is motivated by a mix of the considerations above and a belief that such a system provides in some sense a "fair" access to opportunities;

- reduction in concentration of industry because of concerns about the possible political influence of large organisations.

Much of the difference in opinion that exists about the role of antitrust policy can be traced back to the different objectives proposed for antitrust. We suggest that economic efficiency be adopted as the appropriate objective of antitrust and that the other objectives can be achieved more effectively through alternative instruments of government policy.

2.2.1 *Efficiency Objective of Antitrust Policy*

The efficiency of resource use is a valid objective of economic policy because resources are scarce relative to people's demands for them. More output of one type of good can only be at the expense of a lower production of alternative outputs. Because there are not enough resources to produce all the outputs (both material and "psychic") that people want, a choice must be made between them. People need to decide what goods should be produced and in what quantities, what technologies should be used to produce the desired output and how the goods are to be allocated between different people. Economists use the concept of efficiency to evaluate the success with which an economic system combines scarce resources to satisfy competing wants. This criterion explicitly ignores the effect of different distributions of income on welfare.

In terms of static analysis, efficiency has two dimensions:

- productive efficiency. Productive efficiency exists when it is not possible to produce more of at least one good without simultaneously producing less of another good. At a firm level, productive efficiency means that the firm has adopted the least cost technology and the most efficient organisational arrangement (i.e. there is no cheaper way of producing a given output). In terms of the diagram in Appendix 1, productive efficiency relates to the level of the cost curves. Productive efficiency measures how efficiently outputs are produced. It does not measure how highly valued the outputs are compared with an alternative output mix;

- allocative efficiency. Allocative efficiency involves choosing the "best" combinations of output. Goods are allocated efficiently if no other combination of outputs would enhance the well-being of one consumer without adversely affecting another consumer (or the gainers would not be able, at least theoretically, to compensate the losers in a reallocation of resources). In terms of the diagram in Appendix I, production is allocatively efficient if output is produced up to the point where price equals the marginal cost of production.

Efficiency has a further dynamic dimension:

- intertemporal efficiency. Intertemporal efficiency refers to the degree to which society (or an individual) is finding the optimal balance between satisfying current and future wants through savings and investment. It reflects to the need to consider productive and allocative efficiency in present value terms.

The efficiency criterion can be reinterpreted in terms of minimising the sum of production and transaction costs in present value terms. This will ensure that transactions between people allow the maximum mutual benefit to be derived from scarce resources. In this sense, policies which minimise these costs while maximising the present value of production will maximise welfare. The minimisation of transaction and production costs is equivalent to maximising productive and allocative efficiency. In maximising efficiency it may be necessary to make trade-offs between productive and allocative efficiency or between production and transaction costs.

The monopoly problem, translated into this framework, becomes a problem in which otherwise mutually beneficial transactions do not take place because of transaction costs. While government intervention may reduce the transaction costs associated with the monopolistic good, it might increase production costs or transaction costs more generally. The issue is whether or not the proposed change lowers the cost of transacting and producing overall (in which case it would enable individuals to obtain greater benefits from scarce resources) by more than enough to cover the costs of change associated with introducing the new policy.

The approach suggested focuses attention on the constraints within which individuals transact. The system of property rights a society adopts will have an important impact on transaction and production costs. Government antitrust policies change property rights (including the right to contract) and thereby affect transaction and production costs. A more detailed discussion of the effect of different property rights is contained in Appendix II.

2.2.2 *Non-Efficiency Objectives for Antitrust Policy*

While objectives other than efficiency are sometimes proposed as valid concerns for competition law, these are generally met more effectively and at lower cost through other instruments of government policy. Trade practices and mergers and takeovers have little systematic impact on the non-efficiency objectives most frequently proposed as goals for competition law. As a result, competition law cannot be readily targeted to the achievement of these non-efficiency objectives. Any attempt to achieve non-efficiency objectives through competition law may be at the expense of economic efficiency. Because trade-offs between such different objectives are difficult to make, multiple objectives are likely to create uncertainty and confusion.

These general principles may be illustrated by referring to two objectives that are often discussed in the context of competition law - income distribution and the desire to promote small businesses.

While the design and application of antitrust law affects the income levels of different groups in society, the impact is probably minor compared with the impact of other more targeted government policies (e.g. taxes, tariffs, wage legislation and government expenditures). Furthermore, the incidence of antitrust policies on any one group would be virtually impossible to measure. For example, lower prices for any one commodity would not necessarily favour low income consumers absolutely or relatively because high income consumers of the product also benefit. There is little reason to expect that a policy that favoured consumer interests in relation to producer interests would improve overall income distribution. There is no guarantee that the relevant group of consumers will be poorer than the owners or workers in an organisation or that the use of antitrust in this way would be effective in achieving an improvement in welfare. As Williamson observes:

> "[F]or some products...the interests of users might warrant greater weight than those of sellers; for other products, such as products produced by disadvantaged minorities and sold to the very rich, a reversal might be indicated. But a general case that user interests greatly outweigh seller interests is not very easy to make and possibly reflects a failure to appreciate that profits ramify through the system in ways - such as taxes, dividends and retained earnings - that greatly attenuate the notion that monolithic producer interests exist and are favoured." (1977, p 711)

Other objectives, such as the promotion of small businesses, are sometimes suggested for antitrust policy. However, even if the government decided to promote small business units there would be strong grounds for pursuing this objective directly rather than through competition law. Posner argues that antitrust policy is unlikely to be an effective means of promoting the interests of small businesses:

> "The best overall antitrust policy from the standpoint of small business is no antitrust policy, since monopoly, by driving a wedge between the prices and the costs of the larger firms in the market (it is presumably they who take the lead in forming cartels), enables the smaller firms in the market to survive even if their costs are higher than those of larger firms... The tools of antitrust enforcement are poorly designed for effective discrimination in favour of small firms..." (1976, pp 19-20)

Developments in financial and organisational economics over the last fifteen years emphasise that market economies involve an ongoing competitive struggle between different organisations of different size and with different ownership structures.[7] In the medium term, those organisations that provide the goods and services demanded by consumers at the lowest quality-adjusted prices are most likely to survive and prosper. These arguments suggest that, as a general principle, government intervention should aim to have a "neutral" impact on the form of economic organisation chosen.

2.3 The Nature of Antitrust Policies

Antitrust policies impose constraints on some transactions. They set limits on the right to decide the use and transfer of assets in certain circumstances. Some contractual arrangements and transactions may be prevented if the Commerce Commission or the Courts find that they are not in the public interest. Examples include (in New Zealand) a *per se* restriction on resale price maintenance and the requirements for Commerce Commission approval for major mergers and acquisitions. Such restrictions will increase the uncertainty associated with the use of resources and raise the costs of achieving some transactions.

Typically antitrust policies focus on curbing private sector business activities. State-owned enterprises in New Zealand are subject to the Commerce Act although in the past (and in other countries) such businesses typically have escaped antitrust scrutiny. In the United Kingdom, the Monopolies and Mergers Commission has an explicit role in overseeing and investigating the activities of nationalised industries.

Trade unions, licensed occupations (for example dentists and real estate agents), and the stock exchange are exempt from the Commerce Act. Such groups are subject to separate pieces of legislation that handle antitrust issues.

The current Government has undertaken a sweeping review of regulations affecting market competition. The level of detailed regulation of the market has steadily been reduced and domestic organisations are increasingly exposed to international competition. The Government has removed many statutory monopoly provisions that had the purpose of protecting producers at the expense of consumers. State-owned enterprises are increasingly facing competition in their product markets. Where sound economic or social reasons do not exist for continued statutory protection, the first best approach is to remove that protection. Even where a monopoly position is justified on other grounds and protected by other legislation, attempts by organisations granted statutory protection to raise prices and restrict output will not be acceptable and the sanctions of the Commerce Act should apply.

Accordingly, it would be appropriate for organisations such as producer boards, professional bodies, state owned-enterprises and labour market organisations to be brought within the jurisdiction of antitrust policy with respect to any abuse of market power.

---

7 For example see Jensen and Meckling, (1976), Fama and Jensen, (1983) and (1983a) and Williamson, (1984).

2.4 Summary

In summary, private transactions within the existing framework of government intervention will not necessarily always lead to the most efficient achievable outcomes. The economic rationale for antitrust law arises from the possibility that interventions that change the constraints within which activity takes place, or modify or preclude certain business arrangements, may improve the way resources are used from society's point of view. Making economic efficiency the over-riding objective of antitrust policy does not downgrade an equity role for government intervention; it merely recognises that antitrust policy is more closely suited to the pursuit of the valued goal of efficiency. Equity objectives may be achieved more efficiently through other instruments of government policy.

Antitrust policies should be assessed in terms of the degree to which they reduce transaction and production costs and thereby enable people to improve their welfare. The minimisation of transaction and production costs is equivalent to maximising productive and allocative efficiency.

Because no perfect achievable benchmark exists against which business practices can be assessed, a comparative institutional approach must be adopted. Firms must be seen as comparing attainable alternatives in search of the best possible arrangements.

The next section examines the constraints imposed by the system of property rights and how these affect the costs of transacting and the incentives to produce at minimum cost.

Section 3 Private Arrangements for the Efficient Allocation of Resources

This section examines the variety of private organisational and contractual arrangements that develop within the private property rights system to minimise transaction and production costs. The development of the firm and complex contracting arrangements can in many cases be explained in terms of the minimisation of transaction costs given the existence of "specific assets". Many complex arrangements that people have in the past assumed to be an attempt to consolidate a monopoly position can instead be understood as devices to minimise transaction costs.

The section concludes by observing that the traditional analysis of monopoly, which ignores the existence of transaction costs, is very narrowly conceived.

3.1 Private Contracting and Organisational Form

The transferability of well-defined property rights allows resources to be reallocated to more highly valued uses. The process of exchanging resources is generally achieved through private transactions within the institutional constraints established by the government and by social mores. Market economies involve an ongoing contest between alternative ways of organising economic activity. Private organisational arrangements tend to develop which minimise the costs of carrying out economic activities. People face strong private incentives to devise mechanisms that economise on transaction costs and to undertake transactions that enhance efficiency.

Transactions can be achieved through spot markets, more complex market contracting, within organisations or some combination of these. An understanding of the nature of private arrangements and the reasons particular types evolve is essential for analysing situations in which government intervention might improve on outcomes.

3.1.1 *Market Exchange and More Complex Contracting*

Voluntary contracting through market exchange is one way in which resources can be allocated to the most highly valued uses and competing demands can be reconciled. When someone values a resource more highly than the existing owner, a transfer of ownership which improves overall welfare should be possible. The purchaser should be able to compensate the original owner out of the additional value placed on the resource.

The market system provides a powerful means of aggregating information and coordinating economic activity. It produces, utilises and processes information without the conscious effort of any information collection agency and without individual participants needing to have a great deal of knowledge beyond their own firm's production possibilities or the prices or value of their own labour. Information on prices, reflecting underlying conditions of supply and demand, is the by-product of the many exchanges that take place in the economy. The market process harnesses the incentives of individuals to discover what consumers want and what competitors are doing to meet these wants and, if possible, to find more creative ways to meet consumer needs. Those who are best able to meet consumer needs through luck or skill will succeed while others will fail.

In some circumstances, transactions through the market may impose more costs than transactions arranged within firms. Firms may vertically integrate and produce some of their own inputs rather than buying them from the market. Firms arise when they significantly reduce the transaction costs of obtaining information about alternatives and of negotiating, policing and enforcing contracts.[8] For instance, it would often be extremely difficult for an

---

8 For example, see Coase, (1937), Alchian and Demsetz, (1972), Williamson, (1975) Cheung, (1983), and de Alessi (1983).

input owner to collect information on all the transactions he or she might undertake with consumers or to assess his or her contribution to the final value of a commodity. Firms may be efficient where it is difficult to monitor each individual's contribution to a particular output, or where the possibility of people acting in a self-interested way makes the writing and enforcement of contracts very costly.

Alternatively, the balance of benefits and costs may result in complex contracting arrangements being preferred. Such arrangements can be viewed as intermediate between simple market exchange and firms.

The transaction costs literature emphasises the importance of durable sunk assets that are "specific" to a relationship in explaining why transactions might be organised through vertical or horizontal integration or complex contracting arrangements. Specific assets are assets which cannot be easily adapted to a new use and are significantly more valuable in their current use than in their next best alternative use.

The existence of specific assets increases the likelihood that problems will arise in a contractual relationship. When a firm invests in an immobile specific asset it exposes itself to the risk that other parties to the relationship will strategically "hold-up" the firm for the difference in the value of the assets in their intended use and their value should the specific relationship break down.[9] Klein, Crawford and Alchian term this difference a "quasi-rent". "Hold-up" refers to the possibility that firms will act in an opportunistic manner after the commitment of specific assets to a relationship and attempt to capture some of the quasi-rents.

Hold-up exists only because of difficulties in writing and enforcing complete contracts. It results in one of the parties to the contract having "market power" relative to the other party. Klein notes, however:

> "economic efficiency considerations imply that such behaviour (and its associated transaction costs) should be minimised, but this is a question of contract law, not competition law... economic power is created only after specific investment is made." (1988, p 12)

Because asset owners recognise the possibility of hold-up before they agree to commit assets to a relationship, they will seek to incorporate terms into the contracts they write to protect themselves. However, because it is not possible to specify all possible future outcomes, contracting must be incomplete. This incompleteness creates the possibility that the relationship will be adversely affected by opportunistic behaviour. On the other hand, the specification of tight contract arrangements may reduce the flexibility of the relationship to adapt to changed circumstances. Rigidly-specified contracts may themselves lead to hold-up problems.[10] The possibility of hold-up problems rises with uncertainty and complexity which increase the costs of writing, administering and enforcing contracts. It also becomes more difficult to attempt to cover all possible outcomes. Incomplete contracts which do not specify all obligations under all circumstances will enable *ex post* opportunism. The incentives to act in an opportunistic manner will increase as the degree of asset specificity increases (because the potential gains from hold-up increase).[11] As the frequency of transactions declines, the incentives provided by the desire to gain repeat business and the benefits of a reputation for fair business dealing will decline and hold-up becomes increasingly likely.

The possibility that other parties to the transaction will behave in an "opportunistic" manner once the assets are in place and attempt to renegotiate contract terms is one of the potentially

---

9 Klein, Crawford and Alchian, (1978), p 298.

10 Klein, (1987), p 7.

11 Klein, Crawford and Alchian, (1978), p 298.

serious costs of market contracting. The *ex post* haggling over the investment returns and the possible breakdown of the relationship involve serious costs. Such problems can be resolved through integration into a firm. However, the bureaucratic problems that arise in firms may mean that integration is a costly solution and complex market contracting arrangements would be preferable.

Where hold-up is not a serious problem, market procurement has potential advantages because of the high-powered incentives for performance that markets provide. As the potential for hold-up increases, contracts which govern relationships are likely to become complex in an attempt to reduce *ex post* haggling problems. At an intermediate stage, integration within firms as well as complex market contracting are likely to exist side-by-side. As contracting problems become more severe the difficulties of contracting with external parties are likely to be avoided through organisation within the firm.[12]

Transaction cost analysis has greatly enhanced understanding of complex contracting. Such contracts are often adopted to cope with transaction cost problems. Although they may appear to restrict or prevent certain transactions, they facilitate others and may enhance efficiency overall.

3.1.2 *Self-Enforcing Contracts*

While there is a general assumption that the government exists as the ultimate enforcer of rights, most contracts between businesses are relatively informal and may be difficult or costly to enforce through the court system. Instead, market mechanisms may be used to ensure contract performance. Contracts are often designed to be "self-enforcing". Williamson notes that most disputes including those that could be brought before a court are resolved privately.[13] Whether contracts should be enforced through private arrangements or government enforcement should be determined by the relative efficiency of these alternatives.

The possible loss of repeat business may constrain opportunistic behaviour. However, when the gains from cheating outweigh the losses, the loss of future sales may not be sufficient to constrain opportunistic behaviour. For example, it may be worthwhile for a firm with a well-established reputation to depreciate this asset and obtain a temporary increase in profits.[14]

Klein and Leffler[15]suggest that opportunistic cheating on contracts can be prevented if the potential cheater is offered some form of premium that is greater than any gains that would be achieved by cheating. One method is to offer the potential cheater a price for output that is greater than the average variable cost by an amount that equals the "quasi rents" associated with specific assets. In those circumstances the firm will lose more by cheating than it would gain by acting opportunistically. The higher price could be considered to be "protection money" designed to ensure non-cheating behaviour. It may appear that such a firm is earning above average profits. However, without the payment the desired quality of output will not be produced. If firms entered the market, the price would be forced down and consumers would not be protected against the threat of opportunistic behaviour. Consumers will not agree to purchase at the lower price because they would then expect to be cheated. An assumption that the outcome is inefficient because the price exceeds the marginal cost of production would be mistaken.

---

12 ibid.

13 Williamson, (1983), p 520.

14 Klein and Leffler, (1981), p 616.

15 ibid, p 618.

The apparent profits will be competed away in terms of non-price factors. Expenditure will be made on specific assets such as trademarks, brandnames and advertising, the value of which will be zero if the firm cheats.[16] The premium payment will represent a normal return on this investment. That part of the value of the brand name that is dependent on the performance of the firm is equivalent to a forfeitable collateral bond put up by a firm which may act opportunistically.[17] Klein and Leffler observe that because of the losses associated with cheating when a high price is charged, the high price can act as a signal that the desired quality of a product will be supplied.

Williamson observes that "credible commitments" and "hostages" can be used to support contracting agreements. Williamson cites as an example of the use of hostages Klein and Leffler's work on franchise arrangements. They observe that a poorly designed franchise arrangement may provide incentives for franchisees to shirk on quality. The essential element of a franchise arrangement is the creation of a standard product of predictable quality. Consumers value the information this provides. McDonald's hamburger chains are a case in point. However, because the information about quality applies to all franchise holders, each franchisee has an incentive to free ride on the reputation of the franchise, supply products of lower quality and thereby achieve higher profits. The adverse impact will be spread across all franchisees. The franchisor will recognise this possibility and attempt to structure contracts that provide incentives not to cheat. Klein observes that franchisors can assure quality by:

> "requiring franchisee investments in specific... assets that upon termination imply a capital-cost penalty larger than any short-run wealth gains that can be obtained by the franchisee if he cheats. For example, the franchisor may require franchisees to rent from them short term (rather than own) the land upon which their outlet is located. This lease arrangement creates a situation where termination implies that the franchisor can require the franchisee to move and thereby impose a capital loss on him up to the amount of his initial nonsalvageable investment. Hence a form of collateral to deter franchisee cheating is created." (1980, p 359)

Williamson observes that such an arrangement is tantamount to the creation of hostages to guarantee contract performance.[18] The cost imposed on a franchisee caught cheating will need to be greater than the amount the franchisee stands to gain from cheating because the probability of being caught is less than one hundred percent. The franchisor may be tempted to cheat by terminating franchisee arrangements and purchasing the franchisee investment at a low price. Such action would depreciate the franchisor's brand name and make it more difficult to attract new franchisees. The increased cost of operating the system using employees will act to constrain such cheating.[19]

Williamson notes that the existence of "hostages" may appear to be the result of a stronger party demanding unreasonable conditions from a weaker party who has no choice but to accede to them. However, Williamson suggests that such arrangements may enhance the welfare of both parties:

> "In fact, a comparative institutional assessment of contractual alternatives discloses that efficiency purposes are often served by hostages and that it is in the mutual interest of the parties to achieve this result... More generally, contracts need to be examined *in their entirety*... Principles of justice or competition that look at the

16 ibid, p 626.

17 Klein, Crawford and Alchian, (1978), p 306.

18 Williamson, (1983), p 529.

19 Klein, (1980), p 360.

relation between the parties at the execution stage without examining the *ex ante* bargaining relation are at best incomplete and are frequently mistaken." (1983, p 538)

3.1.3 *Exclusive Dealing: An Example*

Exclusive dealing is an example of a complex contract that can be explained in terms of the existence of transaction costs and the need to protect against opportunistic behaviour. As with many contracting situations, exclusive dealing allows an increase in a dimension of output for which price exceeds marginal cost. In this case, the arrangement is designed to increase the protection from opportunistic behaviour of the owner of a specific asset. Exclusive dealing is a contractual arrangement in which retailers or distributors promise a supplier that they will not deal in products produced by competing suppliers.

Klein, Crawford and Alchian argue that exclusive dealing may have advantages over a standard supplier-customer arrangement where significant investments in assets with low salvageable value are required. They refer to the agreement between General Motors and Fisher Body whereby General Motors agreed to buy substantially all of its closed bodies from Fisher Body for a ten year period and argue that

> "[t]his exclusive dealing arrangement significantly reduced the possibility of General Motors acting opportunistically by demanding a lower price for the bodies after Fisher made the specific investment in production capacity. Since exclusive dealing contractual conditions are relatively cheap to effectively specify and enforce, General Motor's postcontractual threat to purchase bodies elsewhere was effectively eliminated". (1978, p 309)

Vertical integration and vertical trade practices such as exclusive dealing are also used as means of protecting firms' investments in brand names, and reputation in general. If a firm's reputation was hired out by leasing its logo or brand name the lessee would not only be reluctant to make any investments which would increase the value of the asset but would have an incentive to depreciate it. This could be achieved by misleadingly supplying lower quality goods than those which would have been produced by the owner of the reputation capital to consumers who base their purchases on the information conveyed by the logo or brand name. Vertical integration and vertical trade practices may be used to preclude such outcomes.

Marvel explains exclusive dealing as a means of protecting manufacturers' investments in advertising and other promotional and brand-enhancement activities. Manufacturers attempt to charge dealers for the extra custom resulting from these activities by incorporating the charge for the promotional effort into the wholesale price of their goods. Marvel describes the potential problem with this procedure and its solution by way of exclusive dealing as follows:

> "The dealer is able to benefit from the manufacturer's promotional effort while avoiding the promotional charge. If, for example, the additional customers are generated by advertising investments, the promotional charge is avoided if the dealer substitutes a similar, but unadvertised, brand for the advertised product. Exclusive dealing, by preventing this sort of substitution, provides the manufacturer with a property right to his promotional investment." (1982, p 7)

This view implies that the dealer is only able to avoid the "charge" for the manufacturer's promotional effort where the dealer's advice has a significant bearing on the consumer's final selection. For this reason exclusive dealing is more likely to be used where products are technically complex or require substantial after-sales backup and is less likely to be used by producers of goods such as cornflakes, orange juice and aspirin.

A further efficiency reason for exclusive dealing is to protect manufacturers' investments in the development of distributor services by way of training and advice given to dealers. This argument is expressed by Chard as follows:

> "The manufacturer could supply information about management systems, staff training, selling techniques, and after-sales servicing. To the extent that the manufacturer's investment in providing such information can generate customers by increasing the efficiency of a distribution outlet independently of whether the manufacturers' product is sold by the outlet, free-riding possibilities exist unless exclusive purchasing (or a similar restriction, such as a tie-in provision) is employed." (1986, p 41)

Because exclusive dealing prevents substitution of other suppliers' products for the product of the manufacturer supplying the distributor services, it effectively precludes any free-riding on those services.

3.2 Implications for Antitrust

A variety of business arrangements which minimise transaction and production costs have developed within the framework of government-defined property rights. The design of contracts and organisations can be very creative. Innovations in such structures may be expected. Non-standard and complex contracts are often used to cope with the transaction cost problems that would arise with standard contracts. Where such arrangements are mistakenly condemned, significant welfare costs may be incurred.

Within the general property rights framework, strong incentives exist for individuals to solve complex transacting problems when overall gains may be achieved. Private arrangements may develop to resolve problems associated with market power.

Antitrust laws which prevent these arrangements from developing because of a lack of understanding of transaction costs and a hostility towards businesses may result in a substantial cost in terms of efficiency. Firms may be forced to adopt higher cost production techniques that rely less on specific assets for the production of output. Consumers will face higher prices as a result. Firms may have to adopt alternative contractual arrangements that meet the same objectives (of coping with opportunism and specific assets) at a higher cost. The costs will ultimately fall on consumers and overall welfare will be lowered.

Traditional antitrust policy has largely ignored the importance of transaction costs and tended to view any non-standard arrangements and mergers in terms of an attempt to "monopolise" to increase profits. Such a focus is obviously too narrow. Because of the difficulty of understanding many business arrangements and our increasing understanding of the efficiency role many of them play, it is important that we do not adopt a hostile approach to complex and non-standard contracting arrangements.

Antitrust policies will place restrictions on the ability to decide the use of resources. The resulting uncertainty will raise the costs of some transactions and may reduce welfare overall. These considerations have also been largely ignored by traditional analysis.

Despite the strong incentives for private individuals to devise arrangements that facilitate transactions, the existence of transaction costs means that even with well-defined property rights established by the government, private individuals may not undertake all efficiency-enhancing transactions that would be achievable with a change in the constraints. More often, however, transactions are prevented by government interventions that have assigned rights according to criteria other than efficiency. In both situations the modification of existing property rights may improve welfare. Whether or not the government should intervene will depend on whether the costs of such intervention will exceed the benefits and improve efficiency overall. These matters are considered in the following sections.

Section 4 Potential Problems with Private Arrangements

This section discusses when "market power" may reduce welfare. Market power exists along a continuum from the differentiated seller, which gives no cause for concern, to the monopoly situation. No general rules indicate precisely when market power becomes a problem; instead the assessment of antitrust intervention will always come down to a matter of judgement.

The size of any potential allocative efficiency losses depends on the extent to which consumers can satisfy their needs through alternative suppliers or by using alternative products, or by contracting around the problem.

Dynamic considerations modify concern about market power. Monopoly profits play an important role in directing resources to highly valued uses. The profits will eventually attract entry into the market and the market power will be eroded.

4.1 Identifying a Problem

Schmalensee summarises the difficulty of identifying a monopoly problem:

> "Most firms... have some market power; only a few have enough to be characterised as dominant or as monopolies. There is essentially no basis in economics for the existence of a sharp dividing line between dominant firms and others, however, since market power is measured along a continuum." (1987, p 63)

A number of conditions must be met before the allocative efficiency losses associated with market power are significant enough to raise concerns. The market power problem is unlikely to be large if any of the following conditions hold: there are reasonably similar alternative suppliers or substitute products that could satisfy consumer needs at a similar price; goods are internationally traded; potential new suppliers could enter the market; there are no significant "sunk" cost or legislated barriers to entry into the market; or the monopolist and its customers can negotiate around the problem to increase output.

4.2 Alternative Existing Suppliers or Substitute Products

The failure to transact with a particular supplier will not reduce efficiency if there are alternative ways of achieving the desired transaction. The incumbent who attempts to raise its prices above those of alternatives will lose customers to its rivals. Consumers will turn to alternative products or suppliers that meet their needs. As long as the rivals' marginal costs of production are comparable to those of the initial supplier, the forgone gains from trade are likely to be small. For example, if the price of electricity is raised, some consumers may be readily able to substitute gas for their energy needs, if the price is comparable.

Alternative suppliers of similar products may be able to enter the market or adjust their output. The welfare losses incurred when a customer has to turn to another supplier will be small if the products obtained are reasonably close substitutes to those produced by the incumbent and are supplied at a similar price. Where the substitutes are close enough in end use and price, the firm will lose more revenue from reducing its output than it will gain from the increased price. This possibility will constrain its behaviour, with the constraints being tighter the closer the substitute is to the product in question (in terms of end use).

If the good or service is currently imported (in amounts above a minimum threshold) a domestic firm would not have a significant amount of market power. Even when there are very few domestic producers, they will be constrained in any ability to exercise market power by the imported good or service.

If a good that is not currently imported could be imported in response to a relatively small domestic price rise, then the domestic firm will not have a significant degree of market power. The

profitability of importing the good will depend on the off-shore price plus the costs of transport and any other costs such as tariffs.

Where an exported good or service is involved, the firm will be constrained in its domestic behaviour by the world price plus transport costs (assuming there are no other barriers to importing). If the cost of transporting the good back to the country of origin (and any other costs) is not too high, the domestic industry will not have substantial market power.

Because of these considerations, traded goods are less likely to be of concern for antitrust policies.

4.3 Barriers to Transactions

Welfare may be reduced if potentially beneficial transactions are not carried out either by an incumbent firm or by new firms entering the market. The existence of the welfare loss triangle indicates that potentially beneficial gains from exchange are being forgone. Transactions that are potentially beneficial will not be carried out if the following conditions hold:

- transaction costs (given the existing property rights constraints) prevent an incumbent firm with "market power" negotiating with its consumers to find mutually agreeable terms for the supply of additional output. The firm's profits are then maximised by restricting output and raising prices;

- new firms are unable to (profitably) enter the market to carry out transactions with consumers. This is a concern only if the private incentives to enter a market (or transaction) differ from the social benefits that would accrue if entry took place (taking into account all of the trade-offs involved). The threat of new entry has two effects: the new firm may be able to carry out the transactions in question and this possibility changes the incentives of the incumbent firm to restrict output in the first place.

People often describe the factors that prevent transactions taking place as "barriers". The term "barriers to entry" refers to the factors that prevent a new player entering a market and transacting with a consumer. The term "barriers to incumbents" refers to the factors that may prevent an incumbent firm negotiating potentially beneficial transactions. "Barriers to transactions" encompasses both situations.

Barriers to transactions by the incumbent and/or new entrants may be caused by legally defined property rights or by transaction and information costs. Barriers may prevent incumbent firms from increasing their output or other firms satisfying customer needs. The term barrier is often used in a pejorative sense that fails to recognise the positive economic function that is often fulfilled. Potential entrants to all transactions face entry and exit hurdles of one type or another. Some of these are important in facilitating efficient resource utilisation and others reflect unavoidable costs.

The cost of obtaining information prevents transactions by incumbents or new entrants that would take place if information were free. Uncertainty, risk aversion and the possibility of people acting opportunistically prevent exchanges compared with a world in which these factors were absent. These economic realities which prevent transactions must be accepted as limitations on the ability to enhance welfare unless alternative arrangements which lower the costs involved can be identified. Private arrangements tend to develop that minimise transaction, information and production costs. Complex contracting arrangements, vertical integration and investments in reputation are all responses aimed at minimising the adverse impact of transaction costs.

An incumbent may have an advantage (that acts as a barrier to others entering a market) if its existence conveys positive reputation effects which are valued by risk averse customers. If consumers prefer to deal with the incumbent because that reduces their information costs such a situation should not be considered as socially harmful. Alternatively an incumbent may be more efficient than potential entrants. Its rivals may regard this superior efficiency as a barrier to entry but consumers will generally benefit from buying from the most efficient producer.

Private property rights (to the extent that they can be defined and enforced) are legally enforceable barriers to new entrants that may improve the efficiency of resource use. All property rights act as barriers to some transactions while facilitating others. For example, the fact that one is not able to use another person's factory without first obtaining permission is a barrier to some transactions. However, such a barrier is essential if factories are to be built in the first place.

Patent rights that protect the return from research and development will result in more new products being produced than if the rights are not protected. On the other hand, the establishment of such rights will reduce the rate at which new ideas are applied and dispersed once they are discovered. It is often not simple to determine where the balance of rights should lie. For example, an assessment of the trade-off between increasing production of existing products and the incentives to produce new ones would involve consideration of how valuable a new, currently unknown product might be compared with an increase in the output of existing ones. Such a normative assessment would require an estimation of a discount rate for intergenerational comparisons as well as an estimate of the relative value of different products. In all circumstances the establishment of rights involves trade-offs and some transactions will be allowed at the expense of others.

Barriers to a new entrant will be too high if the private incentives for entry differ from the social benefits that would accrue if entry took place.[20] Barriers may be too high from society's viewpoint so that incumbent suppliers are protected from rivals, or too low so that the right to exclusive income from socially valued investments is not adequately protected. Antitrust is usually concerned with the former rather than the latter although both are important for efficiency. Fisher suggests that an important consideration in assessing whether new entry barriers are too high is whether the removal or lowering of those barriers would improve social outcomes. He expands on this principle as follows:

> "An economically relevant barrier to entry is one in which unnecessarily high profits are not bid away by entry. That is a situation in which society would be benefited by entry but in which the attractiveness from the point of view of society is not the same as attractiveness from the point of view of the entrant ... If it is technically necessary to make a lumpy investment to get into the industry, the right question from the point of view of society is whether or not the rate of profit to be earned on the entire activity of entry, production, and sale, including that lumpy investment to get into the industry, is higher than the rate of return which could be earned in other industries (adjusting for risk). The fact that a large investment has to be made at the outset makes this a long-run question nevertheless. In the situation described, there is no reason to suppose that the calculation made by the potential entrant is any different from the calculation which society would wish him to make. There is no reason to believe that there are any social benefits or costs which are not reflected in private incentives. In the situation described, the potential entrant will not enter if the profit he foresees in the long run will not be sufficient to justify the initial lumpy investments. But that is exactly the same calculation which one would make on behalf of society." (1979, p 24)

When barriers to entry are inappropriately scaled, corrective government intervention may improve overall welfare.

Where the private and social incentives for entry are the same (i.e. barriers to entry are "appropriate"), an incumbent firm may still be in a position of "market power". Barriers which prevent the incumbent from increasing output may prevent further transactions being negotiated. Barriers to incumbents will often take the form of transaction costs. Contractual and organisational arrangements and innovation in these may be able to solve some of the problems that arise. Private actors face strong incentives to achieve welfare-enhancing transactions.

---

20 Fisher, (1979), p 23.

Government intervention is most likely to have a positive effect where legislated barriers to entry are too high. Where barriers to entry are appropriately scaled but an incumbent firm is in a position of "market power", government intervention may possibly be considered. Government intervention may improve outcomes if it reduces overall transaction and production costs. It is important that the government does not incur more costs than the potential benefits from further transactions and therefore does not incur any more transaction costs than the costs that prevent a privately negotiated solution.

Three important situations can be identified where the existence of barriers to transactions may result in an outcome that is not the best achievable:

- transaction costs prevent a negotiated solution that would realise some of the forgone gains from exchange;
- firms or industries where legislated barriers to entry are too restrictive, preventing entry into the market by new suppliers;
- situations where sunk costs, particularly in combination with economies of scale, are a significant feature of the investment required for business. These situations are discussed below.

4.3.1 *Barriers to Incumbents Negotiating Further Transactions*

If transaction costs are not high, the incumbent firm can use some forms of price discrimination to increase output and in some cases will reduce efficiency losses. Alternatively, consumers could band together or "bribe" the incumbent to increase output. Such a strategy becomes more difficult the larger the number of customers. Similarly the customers could reduce the risks associated with new entry by contracting to buy from the new entrant before it invests in sunk cost assets. When only a few customers face a few suppliers, the players should be able to contract together to realise any potential welfare gains. However, it is in those circumstances that the costs of discovering prices and coping with opportunism are particularly high. Even if private transactors fail to negotiate an agreement in the presence of specific assets, it is unlikely that the government will be able to improve on the outcome. The fundamental problem of opportunism will remain.

4.3.2 *Scale of Legal Barriers*

Where the government has assigned property rights on political grounds in response to interest group pressure, it may have had little regard to efficiency. Possible examples include occupation licensing, statutory monopolies such as New Zealand Post and the producer boards, labour unions, and domestic firms protected from foreign competition by import licensing. Stringent mandatory safety standards are sometimes imposed to restrict entry.

Joskow and Noll[21] note that regulation is likely to retard entry by new firms because new entrants are likely to be less effectively represented in the political process. Their potential employees and customers are unlikely to know their identity in advance of entry and therefore face more significant costs in organising to offset the influence of established interest groups.

These government-granted monopoly rights may exclude others from access to markets so that potentially beneficial transactions are prevented. People cannot contract with potential alternative suppliers who may be able to produce output more efficiently and supply it at a lower price than incumbent suppliers. For example, under existing law non-union workers cannot be employed, and workers are constrained from joining alternative unions which might better represent their interests.

---

21 Joskow and Noll, (1987), p 17.

Incumbent suppliers in a monopoly position may not face incentives to expand output to the welfare-maximising level. Regulatory barriers may lower both productive and allocative efficiency. Because of the barriers to entry, such positions are not eroded through time by new entrants. Alternative substitute products that are not covered by the regulations may, however, develop and act as some constraint on the monopolist. Rent-seeking for government-protected monopoly positions may involve further costs.

Poorly-designed regulations can act as barriers to transactions by increasing uncertainty. For example, antitrust policy that is phrased in terms of the promotion of competition, when in fact the underlying objective is the efficient organisation of production, can create confusion for producers. Business arrangements that improve efficiency but which reduce rivalry may be mistakenly prohibited by such antitrust laws. Producers will incur costs by avoiding such arrangements because of the risk of antitrust action and will therefore forgo some welfare- enhancing transactions.

The potential for transactions would be created by removal of the monopoly protection. This would allow individuals to contract with alternative suppliers. The ability to contract with others will constrain people in the market to supply output at the lowest possible cost. Clarification of regulations will facilitate transactions that are prevented by uncertainty.

4.3.3 *Sunk Costs*

The requirement to make large sunk cost investments to enter a market may prevent entry. Sunk costs cannot be recovered once the investment has been made; they are assets which have a reduced value in an alternative use. The firm will lose the value of these assets if it leaves the market.

Sunk costs will always be incurred whenever a firm enters a market. The costs incurred in planning and organising a business cannot be recovered if the firm leaves the market. The time taken to locate a building to rent is a sunk cost. Sunk costs are incurred in searching for new products and new kinds of service, the most obvious example being research and development costs. Firms incur sunk costs in advertising, brand names and the development of a market reputation. Costs may also be "sunk" in plant specific to a firm that has little resale value if the firm leaves the market. (A commonly cited example is railway lines, if each railway company must own its own lines.)

The essential point here is not to confuse the high capital cost of entering a market with the presence of high sunk costs. Fixed assets are not necessarily sunk assets. For example, while it is costly to purchase aircraft so as to enter the market for air services, the sunk cost will be minimal if they can be resold at a price discounted only for depreciation. In the absence of sunk costs, the need to buy large capital items before entering a market will not increase the risk of entering the market.

Sunk costs increase the riskiness of entering a market when information is costly to obtain and the future is uncertain. If the investment turns out to be a failure, the investor will lose that part of the investment which is sunk. Sunk costs that are specific to a particular relationship increase the risk that one or other party to a transaction will, after investment, opportunistically renege on agreements reached before the commitment of assets.

Economies of scale in conjunction with sunk costs raise the risk of entering the market when the efficient scale is large relative to the market size. New entrants will rationally fear that they might not be able to gain enough of the market to justify entry (and to be able to produce at minimum cost).[22] They may also fear that the additional capacity created will cause prices to fall below the level necessary to earn a sufficient return on the risky process of entry. However, when domestic producers are able to export, economies of scale will be of less concern.

The result of the risks associated with sunk costs (and particularly in the presence of significant economies of scale) and the costs of coping with them is to reduce entry into an activity.

---

22 Salop, (1986), p 557.

Schmalensee[23] notes that it is not clear in theory or in practice how large sunk costs have to be in absolute dollar terms or as a percentage of overall entry costs before efficiency problems are raised. However, the higher the proportion of sunk costs to the total investment required to enter a market, the longer the expected time required to amortise the costs of entering and leaving an industry and therefore the greater the risks to new entrants.

Private transactors may be able to contract around the problem of sunk costs. Where only a few customers would buy a product that requires a sunk cost investment, a potential entrant to the market could contract with potential customers prior to entry. For example, a gas field developer may obtain from its future customers (e.g. gas wholesalers) a take-or-pay agreement. The result would be to reduce the risk to the potential market entrant and internalise any costs and benefits involved.

Similarly, where the incumbent faces a small number of customers, strong incentives should exist for the parties to come to an arrangement that realises all possible benefits. Where an incumbent or a potential new supplier faces a large number of potential customers it may be more difficult for it to negotiate with them to share the risks associated with entry.

A sunk cost industry will be susceptible to competition from new technologies or new products. Producers are constantly seeking out more efficient ways of producing the desired output. As technology changes the most efficient method of organising production will change.

The risks associated with sunk costs are to a large extent a fact of life. While there might be more transactions if these did not exist, this is not a helpful perspective. The ability to restrict output and raise prices may have been the factor that motivated the incumbent firm to enter the market in the first place. While welfare would be improved further if output was expanded, the alternative may have been the production of no output at all.

The risk associated with new entry may prevent new suppliers entering the market. The same risk assessment may be made by society: the risk from attempting entry may outweigh the potential gains. Where the incentives to enter are the same from the private and social point of view, the sunk cost barriers must be accepted as a fact of life. Government intervention to change the barriers to entry would not be appropriate. Other actions to prevent the incumbent exercising market power may, nevertheless, improve welfare.

Where the risk return assessment does differ, the government may wish to take action to change the scale of the barriers. For example, firms in a concentrated market that requires substantial sunk cost investment may engage in strategic behaviour to raise the costs of entry by a rival. The government may be able to provide incentives not to engage in such behaviour.

Although the barriers to entry may be "appropriate", society may, at least in a short-run sense, benefit if the incumbent were to increase output. Government intervention to change the incentives facing the incumbent may result in an increase in output. For example, price controls which result in the equating of marginal and average prices remove the incentive to restrict output. Alternatively, action that prevented incumbents from colluding or merging may prevent the incumbent firms from restricting output. However, the costs of intervention could well outweigh the benefits. We discuss these issues in the next section.

Where costs are not sunk, a firm will not be able to reduce efficiency by reducing output and raising prices. Any attempt to raise prices would result in entry into the market. In the absence of sunk costs a firm will be able to prevent a rival from entering the market only if the existing firm is able to meet consumer needs more efficiently than alternative firms.

It should be reiterated that sunk costs are an effective barrier only when a firm in a market is not constrained by other producers of the same or substitute products. Other firms may have taken the

23 Schmalensee, (1987a), p 47.

risk associated with sunk costs and entered the market. Imported goods and substitute products will act to constrain domestic producers.

4.4 Dynamic Considerations

Competition is in practice a dynamic process which involves searching out high return opportunities. The prospect of temporary monopoly profits induces firms to innovate or to make sunk cost investments to produce products that are valued by consumers.

Fisher notes that the presence of such profits will lure new businesses into the market. For example, if there are no government barriers to imitation of a new product which is earning high returns, other firms will work out how to copy the product and will begin producing it. They will sell the product at a lower price to encourage new customers to buy from them. Generally, the imitating firm will face lower costs than the original firm (because it will not have spent as much on research and development) and will be able to afford to get into the business at a lower price than its rival. The original innovator will not be able to maintain its high price in the face of competition unless it invests in further research.[24]

Even where sunk costs are high, markets are likely to be contestable in the long term.

"Monopoly" profits are an essential part of the dynamic nature of competition. The prospect of a temporary "monopoly" position provides the incentives for firms to innovate and to make risky investments. Any change in property rights which reduces the ability of firms to retain such rewards may reduce their incentives to "create, notice and exploit opportunities arising in the future".[25]

Littlechild[26] observes that even when a protected monopoly exists, for example through government-imposed barriers to entry, firms have both the opportunity and incentive to discover new products or techniques which might by-pass the monopoly. Similarly, when practices are prevented by the judicial system others will develop to achieve the same objectives. Littlechild observes that if the market is prevented from directly eroding the monopoly position it will continue around the monopolist. Rivals will use alternative processes and products to satisfy consumer needs. Eventually substitute products and processes will erode the dominant position.

In comparing the speed with which the market corrects monopoly problems with the potential costs imposed by the judicial system, Easterbrook notes:

> "the economic system corrects monopoly more readily than it corrects judicial errors. There is no automatic way to expunge mistaken decisions of the Supreme Court. A practice once condemned is likely to stay condemned, no matter its benefits. A monopolistic practice wrongly excused will eventually yield to competition, though, as the monopolist's higher prices attract rivalry." (1984, p 15)

Easterbrook observes that in many cases the costs of wrongly-permitted monopoly are smaller than the costs of competition wrongly condemned. He notes that, in general, a beneficial practice will reduce the costs of production of every unit of output whereas a monopolistic practice imposes losses only to the extent that it leads to a reduction of output. As a result the allocative efficiency loss associated with monopoly will be smaller than the productive efficiency loss associated with the prevention of practices that enhance efficiency.

---

24 Fisher, (1979), p 11.

25 Littlechild, (1981), p 361.

26 Littlechild, (1981), p 359.

While economic theory predicts that monopoly positions will generally be eroded through time, the speed with which such positions decay in real markets is essentially an empirical matter. The effect that sunk costs will have on determining the speed of erosion is also an empirical question.[27]

4.5 Summary: Situations of Concern

The circumstances in which "market power" may exist and give rise to concerns are limited. We have identified that the following three conditions must be satisfied before a potential problem can be said to exist:

- there are no reasonably similar alternative suppliers (actual or potential) of the product concerned and no alternative substitute products would meet consumers' needs at a similar cost. This condition is only likely to be met if the goods are non-traded or, if traded, are subject in New Zealand to high transport costs and prohibitive tariff barriers; and

- barriers to new entrants are high, either because of inappropriately-scaled legal barriers or sunk costs; and

- the barriers to incumbents negotiating for an increase in output that would improve efficiency (e.g. price discrimination or pre-investment contracting) are high. New firms are unable to negotiate with consumers prior to entry to spread the risks of entry.

Intervention will only be justified if the government can change property rights to reduce the sum of transaction and production costs. Such an assessment must take into account the likelihood that market power will be eroded through time without intervention, as well as the risks that intervention will prevent other desirable transactions to the overall cost of society.

27 Schmalensee, (1987), p 67.

Section 5 Implications for Antitrust Policy

This section begins by discussing in general terms the requirements that must be met before government intervention can improve on welfare. It notes that intervention will be justified only if the benefits of intervention outweigh the costs. Many of the factors such as information costs which limit private solutions to problems will limit governments' ability to improve matters. The form of intervention should be chosen to maximise the benefits and minimise the costs.

We discuss in some detail the possible case for, and shape of, intervention on antitrust grounds. In the situations in which market power arises, some mergers, contractual arrangements and collusion may increase market power and therefore reduce welfare. Often such contractual arrangements have offsetting efficiency effects; the prevention of these efficiency gains may outweigh any problems arising from "market power". When a firm already has market power, the government could intervene to change the incentives to produce output through, for example, price controls or common carrier requirements. The imposition of such limits on property rights may, in a static sense, reduce the problems associated with market power. However, over the long term the restrictions may have a serious adverse impact on incentives to produce output at the lowest cost. They may reduce the incentives to invest at all.

5.1 Potential for Government Intervention

Government intervention is justified only if the benefits of intervention outweigh the costs. This can be subdivided into two requirements:

- the government is able to identify potential problems, define (or set limits on) or redefine rights at a cost that, together with any subsequent private transaction costs, is less than the original costs that prevented private solutions;

- overall transaction and production costs are reduced by government intervention. If the government raises overall costs (including the cost of obtaining information and instituting limits on property rights), it may facilitate some transactions but these will occur at the expense of others that may be more highly valued.

Government intervention is likely to be justified only when the social gains from further contracting are high, which means that the transaction costs preventing further private contracting are large or the legal barriers to entry are inappropriately high.

It is important in analysing the alternative institutional arrangements that real world alternatives are compared. Government intervention always has its own costs. Vickers and Hay summarise these considerations by noting that policy should be designed:

> "with a view to minimizing the cost of ... condemning desirable behaviour and permitting undesirable behaviour together with the costs of administering policy." (1987, p 19)

Government intervention which changes property rights will have far-ranging and sometimes unpredictable and unforeseen impacts on private behaviour. The possible effects and costs of intervention include the following:

- government intervention may stop a firm or industry from adopting the most efficient production technology and industry structure. It may prevent the realisation of economies of scale or scope. It may prevent the firm adopting the most efficient organisational form. For example, it may prevent a firm integrating vertically or designing and implementing complex contracting arrangements to cope with the commitment of specific assets to a relationship. The result will be to raise the cost of producing output, and many beneficial transactions may be forgone as a result;

- intervention may increase uncertainty (and thereby dissuade firms from doing things which would increase efficiency or which might be subject to intervention);

- direct costs will be incurred in administering and complying with regulatory rules;

- government rules may fundamentally change market and political incentives in unintended and costly ways. They will influence the incentives to work and invest. Owners of resources have incentives to seek government assistance in excluding the entry of competitors, to disadvantage those who do enter and to adversely affect substitute resources, thereby enhancing the value of the rights they own. They will seek government assistance in the form of interventions to further their own aims. Governments have incentives to respond to organised interest groups and to expand their own activities.[28]

In many circumstances, government intervention beyond that necessary to define private property rights will not improve on the outcomes achieved by private arrangements. The ability of government intervention to enhance efficiency will be limited by the same costs that limit private solutions. The basic problems of scarcity, interdependencies, limits on people's abilities to understand issues, information costs and incentive problems remain. In many situations the problems will be worse because of the severe information and incentive problems facing governments. Politicians and bureaucrats are not always altruistic and they may seek to advance their own interests. Markets usually have a comparative advantage in harnessing widely-dispersed information concerning technical processes and consumer preferences. Because of a government's ability to tax, there may be few constraints which prevent it incurring costs that far exceed any expected benefits from further transactions.

Because the process of investigating and intervening will be costly, it will not be worthwhile to prevent all practices and arrangements that might be considered "harmful". The more restrictive the antitrust rules, the more likely it is that beneficial transactions will also be caught in the net. Detailed investigation of business practices will reduce the potential risks of condemning desirable behaviour and permitting undesirable behaviour but will increase the cost of administering policy. Investigation should be restricted to circumstances in which there is a strong prima facie case that the costs of forgone transactions are high.

Because analysis will often be inconclusive, the assumptions about the general effects of business practices such as complex contacting and mergers will have an important impact on the extent of intervention. A "hostile" approach to business behaviour which ascribes a monopoly explanation to practices not well understood will result in far fewer mergers and other complex contacting arrangements than a "permissive" approach.

Easterbrook[29] argues that because most forms of cooperation are beneficial, the antitrust rules should err on the side of excusing questionable practices; excusing a practice about which we are ill-informed is likely to be less harmful than the alternative.

The design of the overall framework of constraints imposed by the government will have a fundamental impact on the nature and kinds of activities undertaken in the economy. The form of intervention adopted will affect the costs associated with intervention and therefore whether the benefits of intervention outweigh the costs. Government intervention should ensure the following:

- the objectives of intervention need to be well defined. The efficiency objective of antitrust policy should be clearly specified. If it is accepted that distributional issues

28 de Alessi, (1980), p 19.

29 Easterbrook, (1984), p 16.

are pursued more efficiently through other policies, this should be clearly stated. The instruments of intervention should be chosen so as to match the objectives of intervention as closely as possible;

- the rules should aim for certainty - but not at any cost. A clear specification and application of intervention rules will reduce the high costs associated with uncertainty. If firms are uncertain whether or not particular contractual arrangements will contravene antitrust laws, they may adopt more costly arrangements "just in case". Uncertainty in the specification and application of the rules increases the likelihood that antitrust law will be used strategically by firms to raise rivals' costs. Firms may be able to challenge the efficient practices of their rivals and force them to adopt more costly arrangements. If rules are uncertain, firms may be forced to settle antitrust claims even when they have committed no breach. The costs of litigation combined with the uncertainty of an outcome may make that the least costly course of action;

- the rules should be narrowly focused. An attempt to achieve multiple and, in particular, conflicting objectives will increase uncertainty and make it more likely that none of the objectives is met. If the net is cast too widely, transactions that are not of concern will be captured by the antitrust laws, so raising the overall costs.

Solutions which are "perfect" in a textbook sense are not possible either through the free market or by government intervention. The objective of economic policy is rather to select the set of "imperfect" but real world institutional arrangements likely to give rise over time to the most consistently efficient outcome, subject to any constraints imposed on grounds such as social equity or environmental goals. Antitrust rules must be examined in this framework to determine whether they improve welfare.

In many such cases the tools of analysis to make the necessary assessments are severely limited. Demsetz notes:

> "Whether [observed institutional arrangements] should be tolerated, encouraged, or discouraged is a normative matter about which, I believe, there is considerably more ambiguity than economists generally realise... I will state normative positions, but ... such positions are a compound of analysis, empirical judgement, and faith. They could not be derived from economic theory alone ... even if there was complete agreement that policy should serve the interest of consumers or of efficiency." (1983, p 42)

While it is necessary to be realistic in claims about the ability of economic theory to guide antitrust policy decisions, good analysis can greatly improve our understanding of the issues and trade-offs involved.

5.2 Government Intervention on Antitrust Grounds

Antitrust policy is concerned with business arrangements which are believed to reduce overall welfare. Government intervention on antitrust grounds will depend on the particular circumstances and concerns. When legal barriers are inappropriately high, government intervention can take the relatively simple form of changing the scale of these barriers.

When sunk costs (in association with the other conditions described above) exist, government intervention can take a number of forms:

- the government can impose limits on the right to contract if the actions that might be taken by private parties would increase "market power" to a level that would give rise to concern. For example, contracting agreements such as mergers, or collusion or other "restrictive trade practices" that may facilitate restriction of output below "competitive" levels, may not be allowed;

- an alternative approach is to allow such arrangements but to regulate to change the incentives to restrict output once "market power" has been achieved. This approach would be more closely targeted on the actual harmful activity that is the ultimate concern of regulators. Once a firm has achieved a position of market power the government may attempt to change the incentives for incumbents to increase output through price controls, common carrier requirements, or by requiring the break-up of firms.

The choice between these options requires an assessment of the costs and benefits of the approaches. The first approach has the serious disadvantage of preventing many contractual arrangements that could produce very significant savings in transaction and production costs. The costs associated with the strategic use of antitrust are likely to be more significant and administration costs will be higher than the second option. It will be preferable to the second option only if the costs of taking remedial action, or doing nothing once a position of market power has been achieved, are very high.

We consider below the situations in which the practices discussed above might increase "market power" and therefore be a potential concern for antitrust policy. In some circumstances such practices may lead to an increase in market power and therefore a reduction in welfare. However, in most cases the practices are used to reduce transaction and possibly production costs, thereby improving welfare. In some situations the practices will have both positive and negative impacts on welfare and an assessment may be required to determine the net impact (taking into account the costs of doing something about it).

A later section (5.5) discusses further the options that might be followed by the government to reduce the costs when a firm has market power. It notes that serious difficulties are likely to be associated with the options identified.

5.3 Legislated Barriers to Entry

In many situations, the government has established legislative barriers to entry on grounds other than efficiency. The removal of statutory protection of professional bodies, producer boards, state-owned enterprises and unions, for example, would reduce the opportunity for monopoly positions to be abused.

A major constraint on local manufacturers is imposed by imported goods. Because of New Zealand's small market, industrial production is sometimes relatively concentrated. This structure of the market increases the importance of the constraints imposed by imports. Because most goods are traded, overseas competitors can generally act to constrain local producers if trade barriers do not artificially prevent them. Most potential monopoly problems could therefore be solved by the reduction or elimination of trade barriers.

5.4 Mergers and Contractual Arrangements

Mergers and contractual arrangements are generally adopted to minimise transaction costs, to realise production efficiencies and to transfer assets to their most efficient use. Section 3 described some contractual arrangements and the reasons why they have developed. Such arrangements enable output to be produced at the lowest cost. The foreclosing of options for business arrangements in product and input markets may result in very large efficiency losses, particularly in circumstances when an economy is being liberalised and dramatic changes in restructuring are being undertaken.

Mergers and contractual arrangements may raise concerns if they increase a firm's ability to exercise "market power" but do not produce any alternative offsetting welfare improvements. If such arrangements do result in an increase in market power which reduces welfare, antitrust could respond by preventing such mergers and arrangements.

The alternative approach of allowing the transaction or contract to take place and then controlling the exercise of market power once it has been achieved is discussed in the following section.

5.4.1 *Collusion*

Firms may be able to increase their profits by reaching agreement to restrict output and raise prices as indicated by the diagram in Appendix I. Collusion is viable only in markets where sunk costs or inappropriately scaled legal barriers make entry difficult and the market is concentrated. In the absence of significant barriers any attempt to raise prices will result in new firms entering the market and frustrating the collusive agreement. The considerable costs of achieving coordination and policing implicit agreements will prevent successful collusion when many players are involved.

Collusion will be attempted only when the expected benefits from collusion outweigh the costs. Firms will not collude if the demand facing the collusive group is so elastic that the price increases do not justify the cost of collusion. It is always profitable for a collusive group to raise prices above competitive levels provided the administrative costs of doing so do not consume all of the gains from collusion. While there are difficulties in colluding successfully, economists generally accept that, where the number of firms in a market is small and barriers to entry are high, collusion is a possibility.

Even when few players are involved, serious difficulties face potential colluders.[30] A collusive agreement involves a restriction in output and the forgoing of welfare-enhancing transactions. While the cartel will gain overall by preventing these transactions, individual members would gain from expanding output because such a strategy, if it goes undetected, will improve their position. The reductions in output and in firm size that are required for collusion constitute a risky strategy for firms.

Firms may be tempted to compete in terms of non-price characteristics. Such cheating may be difficult to police. Even if cheating is detected, it may be difficult to impose penalties particularly when recourse to the courts is not an option.

The difficulties of collusion include the costs of reaching agreement on the prices to be charged and the amount of output to produce, as well as the costs of any measures necessary to prevent cheating on the agreement. Difficulties will be experienced in reaching agreement on prices for a number of reasons. Sellers will face different costs for producing the output in question. Outputs produced by different members of the cartel may not be perfect substitutes and sellers whose products are more highly valued by customers will want a higher market price. An industry will not produce a single product but a range of products that may be substitutable. Information on the different products may be difficult to obtain. Buyers may undermine collusive agreements by utilising long term contracts.[31]

The agreement must adapt to changing circumstances. Product and process innovations and changes in firms' organisational and financial structures will occur through time. The colluders will experience difficulties in adapting the agreement to such changes in circumstances.

Some contractual arrangements may facilitate collusion by assisting firms in coordinating price and output decisions or in enforcing and providing incentives to maintain agreements.[32] Contractual arrangements give rise to concern only in situations where markets are susceptible

30 Williamson, (1987), p 98.

31 Salop, (1987), p 8.

32 Clark, (1983), p 891.

to collusion. Where it is difficult to establish and maintain a successful collusive agreement it is unlikely that firms will attempt to use contracting arrangements in an effort to collude. Where the conditions for collusion are favourable, contractual agreements may facilitate enforcement of agreements. For example a "most favoured purchaser" clause requires that if, during the period of the contract concerned, the seller offers a price lower than the contract price to another buyer, the seller must simultaneously reduce its price to the contract buyer. The clause has the effect of increasing the cost of discounting, thereby increasing the likelihood that cheating will be detected.

The difficulties of negotiating agreements between a number of firms in an industry to fix prices and reduce output are high in reality where information is costly to obtain, circumstances are constantly changing and participants individually have incentives to cheat. Similarly, such agreements will be difficult to enforce, particularly when recourse to the courts is not possible in the event of a breach.

5.4.2 *Horizontal Integration*

Where sunk costs or legislated barriers restrict entry and markets are concentrated, there may be incentives for firms to cooperate or merge to restrict output and raise prices. A merger of two firms will avoid many of the difficulties experienced with attempts to collude. A merged firm does not have to cope with the problems of opportunistic cheating faced by a cartel. It can adapt to changing circumstances as they arise instead of having to decide how to cope with changes before the agreement is set in place. A merger may reduce allocative efficiency if, prior to merger, each firm acted to constrain the other. Horizontal mergers are one of the major concerns of antitrust policies since it is clear that market power could be increased through a merger which reduced the constraints on incumbent firms.

Williamson emphasises that because of the difficulties of successful collusion, mergers or takeovers are more likely to result in market power. He extends this analysis to suggest that "dissolution of dominant firms is not an idle economic exercise" and that improved economic performance could result.[33] However, the cost of dissolving a firm would need to be weighed explicitly against the potential benefits.

Where a market is unconcentrated and alternative producers or products are available, or the merger will result in only a small increase in concentration, mergers will not raise any concerns. Likewise when barriers to entry are low, horizontal mergers will not raise concerns. Any attempt by the merged firm to restrict output and raise prices would result in entry into the market.

It is impossible to determine precisely the level of market concentration that would raise concerns if two firms were to merge in a situation in which barriers to entry are high. The merging of two firms is potentially a problem only if barriers to entry into the market by other suppliers are high, either because of legislated barriers or because of sunk costs, and there are few or no reasonable substitutes available.

A horizontal merger may provide efficiency gains through improving economies of scale or by increasing the organisational efficiencies of the combined entity. Williamson illustrated the potential trade-offs between allocative and productive efficiency using a simple static model.[34] This illustrates how a small increase in productive efficiency may quickly outweigh any allocative efficiency loss because the productive efficiency gain applies to all output produced and the allocative efficiency loss applies only to the output that is restricted.

---

33 Williamson, (1987), p 106.

34 Williamson, (1977), p 707.

A merger or takeover will allow resources to be transferred into higher valued uses. Mergers and takeovers constitute an important method for investors to ensure that managers act in their interests. A takeover allows the replacement of management that is performing poorly. The threat of takeover provides a powerful constraint on the behaviour of incumbent management. These trade-offs need to be taken into account in assessing whether the costs associated with a horizontal merger outweigh the benefits. The US Merger Guidelines state:

> "although they sometimes harm competition, mergers generally play an important role in a free enterprise economy. They can penalize ineffective management and facilitate the efficient flow of investment capital and the redeployment of existing productive assets." (1984, S-1)

This role has been particularly important in the process of industry restructuring occasioned by recent economic policy changes in New Zealand.

5.4.3 *Vertical Integration and Vertical Contracting Arrangements*

The ability to restrict output and raise prices flows from the ability to control output at any one level of the production process. There is growing acceptance of the view that vertical agreements rarely have anti-competitive consequences.[35]

Possessing a monopoly at more than one vertical level of production generally confers no additional monopoly advantage on a firm although significant efficiency benefits may arise. All monopoly profits can be extracted at any one vertical level of the market so that having control of more than one vertical level does not confer additional benefits to the firm concerned or impose additional costs on society.

Vertical integration may raise the barriers to new entry when a large proportion of the market participants are vertically integrated. A prerequisite for vertical integration to be a problem is that firms at one level of the market are concentrated and will have the ability to restrict output if new entry is prevented. Where concentration is low or moderate, firms are able to contract for their requirements with other market participants and will not be disadvantaged by any vertical integration between different levels of the market. The US Merger Guidelines contain the following observations:

> "In certain circumstances, the vertical integration resulting from vertical mergers could create competitively objectionable barriers to entry. Stated generally, three conditions are necessary (but not sufficient) for this problem to exist. First, the degree of vertical integration between the two markets must be so extensive that entrants to one market (the 'primary market') also would have to enter the other market (the 'secondary market') simultaneously. Second, the requirement of entry at the secondary level must make entry at the primary level significantly more difficult and less likely to occur. Finally, the structure and other characteristics of the primary market must be otherwise so conducive to non-competitive performance that the increased difficulty of entry is likely to affect its performance." (1984, p S-9)

Where one level of the market is concentrated it is possible that problems will arise. For example, vertical integration may restrict the number of independent operators at level one. An entrant may be more reluctant to enter level two if it is forced to engage in "small number" bargaining at level one. Bargaining with small numbers may be costly because of the additional costs of determining prices and the opportunities for strategic behaviour. If the costs associated with small number bargaining are too high, or there are no independent operators at level one, the entrant to level two may have to enter level one simultaneously .

35 Comanor and Frech, (1985), p 539.

The requirement for two level entry is a concern only if the returns to entry from the point of view of an individual firm are lower than from the point of view of society as a whole. Where there are significant economies associated with vertical integration, entrants are likely to enter the market on a vertically integrated basis regardless of the approach adopted by incumbent firms. Even if the existing market structure does deter some potential entrants, the number of existing firms may be sufficient to ensure that the market does not raise efficiency concerns. The need for additional capital to enter at two levels of the market does not constitute a barrier to entry as long as the funds are available at a cost commensurate with the level of risk in the secondary market.

One possible situation where the barriers to entry will be raised is where the need for integrated entry forces a firm to enter at a second level with which it is unfamiliar. Integrated entry into an unfamiliar level may carry a risk premium above that normally commensurate with the risk for that activity. The risk premium may apply because information about the unfamiliar level may be difficult and costly to obtain and lenders may doubt that entrants will succeed at that level and therefore at the primary level as well.

The US Merger Guidelines refer to two other situations in which vertical mergers may potentially give rise to problems. They note that firms in an industry with relatively few competitors may integrate forward into retail distribution in order to enforce collusive agreements that otherwise could not be enforced because of secret price cutting. The Guidelines note:

> "a high level of vertical integration by upstream firms into the associated retail market may facilitate collusion in the upstream market by making it easier to monitor prices." (1984, p S-10)

The problems with enforcing collusive agreements were discussed earlier. The concerns about vertical integration in relation to collusion are raised only in the unusual situations in which collusion is a possibility. At a minimum, barriers to entry must be high and the market concentrated.

The further problem raised by the US Merger Guidelines[36] is that a firm subject to public utility regulation may integrate with a supplier in order to shift the focus of the profits from its basic industry to the unregulated upstream industry. For example, price controlled electricity producers may integrate upstream into gas or coal markets.

The concerns raised by vertical contracting arrangements are that they may facilitate collusion among rivals or may be used by a firm to exclude its rivals. For example, the Vertical Restraints Guidelines[37] suggest exclusive territories may be used to facilitate collusion among dealers if dealers are awarded exclusive territories by all suppliers of a product. The restriction would limit the number of dealers that must agree to raise prices or restrict output and protect colluding dealers from the threat of entry. Suppliers may wish to facilitate collusion among dealers when it is difficult to organise collusion among themselves and they could share in the dealers' higher profits.

The second possible problem with vertical restraints is that they may exclude rivals either by raising the cost to rivals of a vital input or by raising their cost of distribution. For example, an exclusive dealing arrangement may force another supplier to secure alternative independent outlets or to integrate vertically into distribution. An alternative is that a firm at any stage of the production process may enter into an exclusive arrangement for the supply of a vital input, leaving its rival with no alternative source of supply.

---

36 US Merger Guidelines, (1984), p S-11.

37 US Guidelines for Vertical Restraints, (1985), p 6.

These arrangements may cause rivals in the market to face higher costs so that they may be prevented from entering or expanding into a market, or may be forced to leave the market.[38]

Comanor suggests that vertical agreements may be of concern because the preferences of marginal consumers can determine sellers' pricing and marketing strategies. He suggests vertical restraints may be imposed to encourage distributors to supply certain consumer services. If marginal consumers value dealer-provided services more than infra-marginal consumers, the level of such services could be too high. On the basis of this argument Comanor concludes that:

> "[a]ll that this analysis has demonstrated is that consumer surplus *may* decline if additional services are provided, as might the sum of consumer and producer surplus. Thus, there is no basis on which to conclude that vertical restraints will always enhance economic efficiency." (1985, p 998)

The point made by Comanor is a specific version of the general argument[39] that in virtually all markets there are differences in the preferences of marginal and infra-marginal consumers regarding the price, quality and other attributes of goods and services. However, it would be impractical to design antitrust policies to make every firm cater to the "average" consumer, having "average" tastes and "average" income. The information requirements, administration costs and practical difficulties arising from this form of intervention would be enormous. At the same time the potential and somewhat hypothetical gains would be minimal. Market economies provide incentives for firms to create a comparative advantage in supplying particular groups of consumers. Firms which neglect their "infra-marginal" customers risk losing them to market niche suppliers who tailor their products and services to particular clienteles of consumers. In many markets, firms attempt to establish ongoing customer relationships with infra-marginal consumers and place special emphasis on meeting their requirements. For these reasons the practical relevance of Comanor's contribution, although of some theoretical interest, is limited from a policy perspective.[40]

In general, vertical contracting arrangements have a neutral or pro-efficiency impact. The US Guidelines for Vertical Restraints note that :

> "the appropriate focus of the antitrust laws should be the effect of restraints on competition among manufacturers of competing brands - interbrand competition - rather than their effect on competition among dealers of a single manufacturer's brand - intrabrand competition... Restraints on interbrand competition may have a significant negative impact on economic welfare. By contrast, vertical restraints that only affect intrabrand competition generally represent little anticompetitive threat." (1985, p 4)

Vertical integration is usually motivated by efficiency considerations. In particular, vertical arrangements are often designed to cope with opportunistic behaviour in the presence of specific sunk cost assets. The US Guidelines for Vertical Restraints note the following benefits from vertical contracting arrangements:

> "vertical restraints that limit the number of outlets may lower distribution costs by enabling each distributor to obtain scale economies, to spread such fixed costs as facilities and training of service personnel over a higher volume of sales, and thus to lower the cost of distributing a product. Second, restraints such as exclusive distribution may facilitate entry of a new producer into a market by enabling distributors to recover initial market development costs. Third, limiting the number of distribution outlets

---

38 US Guidelines for Vertical Restraints, (1985), p 6.

39 See Comanor, (1985), pp 990-991.

40 Klein and Jennings, (1988), p 18.

may be the most efficient method of ensuring the provision of pre-sale demonstration and other informational services that consumers want and that are necessary to effective marketing of a technically complex product. In those circumstances, in the absence of vertical restraints a dealer may invest too little in such services because other dealers that do not provide the services may 'free ride' on the services that the dealer has provided... Fourth, vertical restraints, such as exclusive dealerships, may allow a supplier to protect its investment in services provided to dealers (e.g. advertising) by preventing dealers from using those services to sell the goods of other suppliers. Fifth, vertical restraints - for example, requirements contracts - may permit firms to allocate costs or risks among themselves in a manner that may permit the accomplishment of transactions that otherwise would be impossible or at least much less feasible. Finally, vertical restraints can improve product quality and safety and reduce transaction costs in numerous circumstances." (1986, p 6)

5.4.4 *Predatory Pricing and Other Strategic Behaviour*

Where there are a small number of firms in a market, the behaviour of one will affect the best decision strategy for the others. The best plan of action for one firm will depend on the choices made by another. Firms will attempt to influence the other players' choices in a way that will maximise the first firm's returns. Such behaviour is termed "strategic".

Strategic behaviour is part of the normal striving to obtain a better outcome for self-interested individuals given the constraints imposed. It may have the positive effect of discouraging firms from entering the market when their entry would not improve welfare. Von Weizsacker notes that, in some circumstances, if established firms do not take action to exploit strategic behaviour to deter entry, too much entry generally occurs when scale economies are present.[41] Alternatively, an incumbent firm may be induced by the threat of entry to undertake additional innovation. If the innovation is socially valued, the strategic behaviour will not adversely affect consumers.[42]

Strategic behaviour is a concern for efficiency policy only when it leads to an inefficient outcome compared with an alternative achievable outcome. Firms may behave strategically to raise barriers to entry into a market or to force a competitor to leave the market. If such action enables the incumbent firm to restrict output and raise prices in the long term, efficiency may be reduced. Such strategies are only feasible in the presence of sunk cost barriers to entry and a concentrated market. The presence of sunk costs means that entry into the market is difficult. Moreover, sunk costs can act as a credible threat of an aggressive response to any entry attempt.[43]

While it is easy to tell a story about circumstances in which strategic behaviour will reduce efficiency, or make theoretical assumptions and prove an inefficient outcome, it can be difficult to identify such situations in practice and even more difficult to demonstrate that the government can improve outcomes by intervening to prevent or modify such strategic behaviour. Strategic behaviour that is allegedly efficiency-reducing will not be readily distinguishable from "competitive" behaviour. The information required to distinguish such behaviour may be difficult to define in theory and even more difficult to define in practice.

Firms that are losing market share to rivals will usually claim that this is the result of unfair behaviour. Any efficiency laws introduced to restrain strategic behaviour will themselves be used strategically to harm rivals. The abuse of the current antitrust laws in this way is discussed below.

---

41 Von Weizsacker, (1980).

42 Vickers and Hay, (1987), p 16.

43 ibid, p 24.

When entry into a market is difficult because of sunk costs, strategic behaviour may be used to raise the barriers into the "dominant" firm's market. Firms may position themselves to discourage new firms from considering entry into the market or they may respond when entry takes place. Pre-entry positioning takes the form of "excess" investment in capacity, research and development, promotion, and the offer of multiple brands. These investments may raise the costs of entry to potential rivals (because they will need to match the research and development outlays or spend more on advertising to establish themselves in the market) or signal that the incumbent will react aggressively to any entry attempt. However, unless investments such as advertising are valued by customers and provide useful information, such investments will merely raise the costs of the incumbent firms, making entry by a new firm less difficult.[44] Threats that are made at this stage must be credible if other firms are to be deterred from entering the market.

Firms may react after entry to the market has occurred. For example, the incumbent may be able to raise rivals' costs by vertical integration, or to force them from the market by "predatory" pricing.

Krattenmaker and Salop[45] suggest that firms may vertically integrate as a strategy to raise their rivals' costs and thereby exclude them from the market. The conditions for this to be a successful strategy are as described in the earlier section on vertical integration, i.e. a concentrated market with high barriers to entry. The strategy of raising rivals' costs may be more successful than predatory pricing (described below) because the firm does not incur substantial costs in "driving" a firm from the market. The regulatory process may be used to strategically raise rivals' costs. A firm may challenge a practice such as exclusive dealing that is employed by a rival but not by itself. The costs imposed by the legal system will be borne largely by the rival.

Predatory pricing is a strategic behaviour that has received a lot of attention. It involves a firm reducing its prices in a strategic attempt to drive a rival from the market. The possibility that predatory pricing is widely used is generally regarded with scepticism. Stringent pre-requisites must be satisfied if predatory pricing is to be a profitable strategy. If a firm wishes to drive an equally efficient competitor from the market it must price below its own cost of production. As the firm lowers its price it attracts a larger and larger market share. Because it is pricing below its own cost, this increases its losses. Moreover, if predatory pricing is to be a profitable strategy, the monopoly profits earned once competitors have been driven from the market must exceed the losses initially incurred. Not only do the losses occur before the profits and therefore have a relatively greater present value, but the firm faces the additional problem of re-entry. It will be very difficult to sustain a monopoly position in the face of rival or potential entrants into the market.

If the industry specific capital of the target firms is durable, or the sunk costs confronting new entrants low, the predatory firm will be likely to face competition as soon as it attempts to raise prices to reap the profits of its predation. Predatory pricing requires customers to take actions that eventually harm themselves. Where there are only a few customers they are likely to recognise the harm they will do to themselves if they allow the predator to drive its rival from the market. Where there are many customers each will stand to gain in the long term if the new rival remains in the market but in the short term they will be better off to take the predator's lower prices. They will therefore be tempted to rely on the efforts of others to ensure the rival's survival while taking the interim lower prices of the predator. It is possible that all firms will take the short term view and the predator's strategy may be successful.

---

44 Posner, (1976), pp 92-93.

45 Krattenmaker and Salop, (1986), p 214.

Predatory pricing would be a more feasible strategy if the predator did not have to lower its prices for all output produced. If it were able to price discriminate successfully it would incur lower costs in the predatory phase. If predatory behaviour is successful in sending a signal to all potential entrants into the market in question (and other markets the firm might be dominant in), the strategy might bring higher payoffs and therefore be more likely to succeed.

In general, though, claims of predation need to be treated cautiously. A recent US Supreme Court decision criticised a predatory pricing scenario as follows:

> "a predatory pricing conspiracy is by nature speculative. Any agreement to price below the competitive level requires the conspirators to forgo profits that free competition would offer them. The forgone profits may be considered as an investment in the future. For the investment to be rational, the conspirators must have a reasonable expectation of recovering, in the form of later monopoly profits, more than the losses suffered... the success of such schemes is inherently uncertain: the short-run loss is definite, but the long-run gain depends on successfully neutralizing the competition. Moreover, it is not enough simply to achieve monopoly power, as monopoly pricing may breed quick entry by new competitors eager to share in the excess profits... For this reason, there is a consensus among commentators that predatory pricing schemes are rarely tried, and are more rarely successful." (US Supreme Court, Matsushita Electric Industrial Co Ltd v Zenith Radio Corp, 1986, reported in *Antitrust and Trade Regulation Report*, 50, p 573)

While the economics of strategic behaviour is a major area of current economic research, the results to date have been far from conclusive or practical. Although it is possible to specify circumstances under which strategic behaviour may cause problems, equally there are circumstances in which it improves the efficiency of outcomes. Until further research allows more conclusive findings on circumstances in which strategic behaviour gives rise to concerns, government intervention on these grounds is unlikely to be justified.

On the overall importance of strategic behaviour and its implication for antitrust policy, Vickers makes the following observations:

> "Recent developments in the theory of industrial organisation have added considerably to our understanding of the workings of competition between the few. Although the perspective gained should and will influence the making and the implementation of competition policy and industrial policy, the new theory has not delivered generally applicable policy guidelines, and it is unlikely that it will do so in future." (1985, p 60)

5.5 Arrangements to Increase the Output of Incumbents

Where firms in a concentrated market are relatively unconstrained by alternative potential or actual suppliers or products, they may reduce efficiency by restricting output. Government intervention to control prices or otherwise modify property rights may induce an increase in output and therefore an overall improvement in efficiency. While there are significant problems associated with taking action to regulate monopolies, this may be preferable to incurring the large costs associated with preventing mergers and other contractual arrangements.

Experience in the United States has demonstrated that the process of regulating "monopolies" can be slow and wasteful, with the regulatory body unduly sensitive to political pressure from federal, state, trade union, managerial, shareholder or consumer interests. Regulations ostensibly enacted to benefit consumers frequently appear on closer examination to have been designed instead to erect barriers to competition, protect established firms and enable them to earn high profits. As a result, the accent today is on deregulation and an enhanced role for generally applicable efficiency laws.[46]

---

46 Sharpe, (1984), p 49.

5.5.1 *Price and Rate of Return Controls*

Regulations designed to change the incentives facing producers may induce firms with some market power to increase output and improve resource allocation. Price control will change the incentives for the production of additional output. A differentiated seller prices above marginal cost because the marginal revenue from additional sales is less than the average revenue. Price controls could ensure that average and marginal revenue were equal. The producer would face incentives to increase output if the controls were set at the appropriate level. The major problem facing regulators is in obtaining the information relevant to setting the price at the "appropriate level" without distorting in other ways the incentives to produce output efficiently.

One price rule that has been favoured in the United Kingdom is the equivalent of a "CPI-X" rule. The prices of a regulated monopoly are allowed to increase each year by the movement in the consumers' price index (CPI) less an amount X which represents productivity gains. The attraction of the rule is that it is simple to understand, it prevents cost-plus pricing and may be less subject to manipulation by the regulated company than some of the alternatives. However, it has a number of drawbacks. If the price is set too high the firm will earn high profits and the pressure to contain costs will be limited. If it is set too low the level and the quality of services may suffer as the firm finds it impossible to earn a reasonable rate of return. There is no unambiguous way of determining an appropriate allowance for productivity gains. X also is affected by the price controls if the X in the formula is related to actual productivity improvements. There is no reason to believe that the CPI is a good indicator of changes in costs in the regulated industry. Where the business of the regulated natural monopoly is growing and the average cost of supply is declining, the formula can lead to increasing profits and a decrease in the pressure on the company to operate efficiently.[47]

Rate of return and price regulations have been criticised because they may reduce the incentives to cut costs, and encourage over-capitalisation. One of the major problems that arises from rate of return regulation is termed the Averch-Johnson effect. If the allowed rate of return is greater than the cost of capital and if the regulatory body effectively constrains the firm to earn its allowed rate of return and no more, then the profit maximising regulated firm will have an incentive to inefficiently substitute capital for other inputs.[48] On the other hand, where an organisation is required to earn a rate of return that is higher than would be required in a competitive situation, the firm will tend to produce its output by using a less capital intensive method of production than would an unconstrained organisation. The result of rate of return regulation may be that the output of the regulated organisation will be produced at a higher cost.

The establishment of a regulatory body may cause the politicisation of the regulation procedure. The result may be to delay the implementation of justifiable price increases. Alternatively, pressure may be imposed to provide special treatment for particular customers.

5.5.2 *Competition for the Market*

Competition for the monopoly market can occur without regulatory intervention where competition within the market is not possible. Rival firms can in effect bid for the right to supply the whole market. Firms will offer to enter into contracts with buyers. In this bidding competition, the firm offering buyers the most favourable terms will obtain their patronage. If the number of bidders is large or if, for other reasons, collusion among them is impractical, the contracted price can be very close to the per-unit production cost. If one bidder can do the

---

47 Veljanovski, (1987), pp 159-162.

48 Hammond, (1986), p 53.

job at less cost than two or more, the bidder with the lowest price for the entire job will be awarded the contract. The lowest bid price need not be a monopoly price.[49]

Franchise bidding is the formal competitive tendering or auctioning of the legal right to be the sole supplier of a service of given quality. Two different types of scheme are possible. The franchise could be granted to the bidder who agreed to supply a certain quality of product to the market at the lowest price. Here the monopoly profits are bid away by the initial auctioning process as in the above case. Price and output are bid down to competitive levels. Alternatively, the franchise can be awarded to the person who bids the most for the right to supply the market. The supplier would be expected to charge monopoly prices but the tenderer would capture the monopoly rents in the tender. Such a system does not solve the problem of monopoly and the welfare costs associated with monopoly would remain.

A number of problems exist with franchise bidding which must be weighed against the cost of monopoly.

(a) Where the agreement is to supply a certain quality of service, problems may arise in defining and subsequently enforcing the quality standard. In general the franchisee will supply a number of products. The regulator may have difficulty in assessing different sets of prices. When the the franchise has been obtained the successful bidder may be in a position to lobby the regulator for changes in technical standards, quality of service etc.

(b) Problems arise because of the costs of writing complete contingent claim contracts under conditions of uncertainty with respect to technology, demand, supply conditions, inflation and so on. However, this is a general problem that arises with all contracting and is not specific to franchise bidding. The contracts require the prospective franchisee to specify the prices at which the service will be supplied in the initial period and, if price changes are to be made in response to uncertain future events, the conditional terms under which service will be supplied in the future. As well, it is necessary to specify the nature and severity of the penalties for infringing the original terms of the contract. Such contracts are generally regarded as complex to write, negotiate and enforce.

(c) If the franchise contract is renewable, existing franchisees may have a substantial advantage over competitors during the refranchising period. These include familiarity with and possible influence over the regulatory agency. The franchisee may have a greater feel for the factors which will most influence officials making the decisions. Sunk costs may confer on the existing company cost advantages over new entrants. The latter advantages can be dissipated by requiring the existing franchisee to sell capital assets to the new franchisee, though this may raise valuation problems. On the other hand, if there is a substantial chance that the incumbent would not win the franchise in subsequent periods he may be deterred from investing at a proper level.

(d) The initial award conditions may be artificial with applicants possibly making unrealistically low bids. This may be a function of the expected scope for renegotiating a franchise once it has been awarded. The benefits of incumbency may be taken into account in the first bid.

In summary, franchising can involve a significant administrative apparatus similar to that associated with other detailed regulation. Thus franchising can lead to agency capture and evolve into a complex regulatory scheme.

---

49 Demsetz, (1968), pp 56-57.

5.5.3 *Common Carrier Approach*

The common carrier approach is designed to reduce the barriers to entry to one part of the market that exist because of the need to incur large sunk costs at another level of the market. A common carrier provision imposed by the government modifies the property rights of existing asset owners. It reduces the ability of the owner of an asset to exclude others from using it. The common carrier approach operates for a number of public utilities in other countries. The basic feature of this approach is that a public utility or a regulated private utility owns the infrastructure (such as an electricity transmission system) which it leases on a common carrier basis to separate operators which provide services. This approach has been used in the United Kingdom, for example for the provision of regional television, and in Canada for gas supply pipelines.

The principal advantages of the common carrier approach are that it restricts the potential losses associated with lack of actual or potential alternative suppliers; it facilitates easier market entry by prospective service providers who would otherwise have to enter simultaneously the sunk cost level of the market; and it allows simpler regulatory and administrative arrangements than if vertically integrated markets were subject to controls.

Common carrier provisions can raise the cost to the industry where economies would otherwise have been achieved by vertical integration. It will reduce the incentive to invest if others can make use of the investment without bearing the risk of the investment. Joint ownership of common facilities by two or more industry participants may alleviate this problem in some circumstances.

More innovative use of common carrier arrangements may facilitate further transactions. For example, several companies may construct a transmission system, with each receiving rights to capacity in proportion to their contribution to the construction and fixed operating costs. An owner can use the capacity rights or sublet them or sell them. If a line has excess capacity, a potential user may be able to bargain for rights to its use between different part-owners. The result is to introduce alternative transactors even when the number of production units is small.[50]

5.5.4 *Public Ownership*

Public ownership has been suggested as a means of facilitating further transactions that would improve efficiency. This is based on a belief that public organisations can be required to act in the public interest, and that the government could force an organisation it owned to increase output more readily than if the organisation was privately owned.

State ownership as a response to increasing the output of price searching organisations has many problems. In particular, the costs of controlling the divergence of interest between the owners and managers of an organisation are achieved more efficiently in private rather than public organisations. As a result, there is a general presumption in favour of private ownership of commercial enterprises on efficiency grounds. State ownership makes organisations more susceptible to potential interference designed to benefit some groups at the expense of others. State enterprises have not proved easy to control because of the lack of incentives for managers to cooperate. There is no reason why the cost of obtaining the information necessary for regulating behaviour could be obtained more cheaply from a state organisation.

State control does not prevent the organisation from using its monopoly position. The New Zealand Business Roundtable study of the telecommunications market documents the extent to which the former Post Office exploited its monopoly on long-distance services to set prices for toll calls at well above marginal cost, and used the revenue to cross-subsidise local calling.

---

50 Smith, (1987), pp 25-26.

Monopoly rents are likely to be captured by managers in the form of an easier life and more perquisites and by workers through soft wage settlements. The absence of capital market competition typically means that state enterprises are less concerned with maximising profits than their private counterparts.

5.6 Summary

In some circumstances, organisations (in input and output markets) may exercise market power in a way which reduces welfare. Government intervention which prevents particular mergers or contractual arrangements or regulates firms which have market power may improve welfare. However, intervention has costs. It may prevent a firm from adopting the most efficient production techniques or contractual arrangements, it may increase uncertainty, and costs may be incurred in administering the policy. The government will be limited in its ability to solve market power problems by the same cost factors that limit private solutions. The costs must be weighed against the benefits in designing antitrust rules and in deciding when intervention is justified.

Section 6 The Economics of Law Design and Enforcement

The cost of intervention on antitrust grounds will be affected by the design of the law and the system of enforcement adopted.

The law should be designed to minimise the following:

- the cost of condemning desirable behaviour;
- the cost of permitting undesirable behaviour;
- the cost of administering and complying with policy.

The objective of antitrust law is to minimise the efficiency costs associated with the exercise of "market power". The danger of such legislation is that economic arrangements that improve overall community welfare will be mistakenly condemned or discouraged. The costs of enforcing antitrust laws include the costs of public enforcement agencies and the court system; the private legal and economic inputs used; the considerable amount of management time taken in complying with the laws; the effect of wrong decisions including the deterring of practices that would enhance overall efficiency; the use of the law in a strategic manner to disadvantage rivals; and uncertainty about outcomes.

6.1 Design of the Law

6.1.1 *Objective of the Law*

The law should be "clear, capable of a fair and strict enforcement, and [be] so enforced".[51] The objectives of antitrust policy should be clearly spelled out in the law. Any analytical tools that would assist in interpreting the objectives may also be incorporated into the law. If these are part of a coherent, consistent conceptual structure they should assist the interpretation of the law. In some modern statutes the intent of policy is almost impossible to discover with certainty because of the extent of the detailed prescription that is included in an attempt to close all loopholes.[52]

The scope for rent-seeking and use of the law in inefficient ways will be minimised where the objective is clearly specified, conflicting objectives are absent and the law is administered in a transparent manner. The clarity of the law will be assisted by refusing to extend it into areas where it is not essential.[53]

A trade-off exists between the incorporation of general or specific rules into law. The adoption of a detailed set of rules rather than a general standard involves costs both in detailing the standard initially and in revising the rules as conditions change. They will become obsolescent more quickly than general rules. The more precise a rule is, the more likely it is to open up loopholes and to permit by implication behaviour that the rule was intended to forbid.

The benefits of specific rules are that the rules will better guide the courts and peoples' actions in designing business arrangements. The existence of specific rules limits the scope and hence the cost of a judicial inquiry; in effect it results in a search for a local maximum rather than a global one.

---

51 Franks and Baxt, (1988), p 4.

52 ibid, p 3.

53 ibid, pp 10-11.

If broad rules reduce the certainty of the scope and applicability of the law, the deterrent effect will be reduced. The vagueness of the law will also increase the likelihood that legitimate behaviour is condemned, which will further reduce the deterrent effect (since this is dependent on the difference in the expected punishment of lawful and unlawful conduct). It is also more likely to deter some legitimate activities.[54]

Broad rules could be combined with detailed guidelines (as issued by the United States Department of Justice) to obtain the benefits of both approaches: a law that did not have to be changed frequently, and a more detailed guide to acceptable behaviour.

The way antitrust laws treat mergers and other complex contracting arrangements should not bias the choices between the arrangements adopted. A different standard for different contractual arrangements (e.g. mergers and trade practices) runs the risk of distorting decisions regarding business organisation and encouraging the adoption of one practice for antitrust rather than efficiency reasons.

6.2 Enforcement of the Law

Three issues are raised by enforcement: remedies, enforcers and procedures.

6.2.1 *Remedies*

The basic objective of a remedies system is to deter people from violating the law by making it costly to engage in certain activities. Posner notes[55] that compensation is a secondary objective because an effective enforcement system will minimise the need for compensation and should ensure that it is obtained as a by-product of deterrence.

In general, the imposition of fines is an efficient way of imposing costs on offenders. Most penalties can be converted into an equivalent monetary value. The major advantage of a system of fines is that the resource costs of imposing fines are minimal. Fines involve little waste: the loss to the defendant who is fined is offset by an equal benefit to taxpayers or those who receive compensation. In contrast, the implementation of an imprisonment term imposes real resource costs on society. Structural remedies such as divestiture may be costly to achieve. A general rule may be that a monetary penalty should be preferred in an antitrust case, and non-monetary penalties used only where monetary penalties are infeasible.[56]

The system of remedies should provide optimal incentives to potential violators; it should impose a penalty on potential offenders at the least possible cost; and incentives should be provided for consumers to take efficient precautions.

- Incentives to Violators

To provide the appropriate incentives to potential offenders, the expected cost of violating the law should be set equal to the harm imposed on society by the activity (including any wealth transfers that occur). If the penalty is set too low, the potential offender will not face the appropriate costs of the action. If costs are too high, acts that risk being judged illegal but which confer greater benefits than harm to society will be prevented.

Even with zero enforcement costs it would not be worthwhile to deter all antitrust violations because they may simultaneously bring benefits (although this will depend on the initial

---

54 Posner, (1986), pp 513-514.

55 Posner, (1976), p 221.

56 ibid, p 223.

definition of a violation). For example, a merger that increased allocative efficiency losses but increased productive efficiency by a greater amount should not be prevented by antitrust laws.[57]

Enforcement involves costs which will rise as increasing resources are devoted to deterring antitrust violations. Simultaneously, the expected gains will decline. It will not be efficient to prevent all antitrust violations. It is worthwhile to enforce the law only to the point where the marginal social costs and benefits are equal.[58]

Stigler notes that while the enforcement agency could easily apprehend most guilty people if no limits are placed on charging and convicting innocent people, the costs will outweigh the benefits:

> "In any real enforcement system, there will in fact be conviction and punishment of some innocent parties, and these miscarriages of justice impose costs of both resources and loss of confidence in the enforcement machinery. The costs of defense of innocent parties, whether borne by themselves or by the state, are part of the costs of enforcement from the social viewpoint. The conviction of innocent persons encourages the crime because it reduces the marginal deterrence to its commission." (1970, p 528)

Where the probability of detecting an antitrust violation is less than one (detection is not one hundred percent certain), the penalty imposed on an offender who is caught should be adjusted upwards so that the penalty imposed multiplied by the probability of being caught is equal to the social cost (i.e. the cost to others) of the violation. It is the expected value of the penalty that should be set equal to the social cost (including wealth transfers) imposed by the activity. As the probability of detection and conviction falls, the fine should be increased to ensure that the expected cost of violation is equal to the social cost. This is the justification for the use of multiple damages. The damages should be set at a level that takes into account the probability of detection and conviction.[59]

It is relatively simple to specify theoretically a set of rules that would efficiently deter antitrust violations. The optimal remedy is established when the penalty divided by the probability of detection and successful prosecution just equals the welfare loss triangle plus the monopoly overcharge. In reality finding the appropriate level of the penalty is much more difficult to achieve. The major difficulty is determining the social costs that are imposed by antitrust violations (for example it is necessary to know the elasticities of demand and supply over a range of outputs), and the probability of detection.[60] Nevertheless such an analysis must underlie the design of enforcement whether or not it is explicitly spelled out.

---

57 Alternatively, mergers that have an overall positive efficiency effect could be allowed by the antitrust laws. Such an assessment may be very difficult for the courts to cope with. It may be preferable for the firms who have the best access to information about productive gains to make these assessments themselves in weighing them against the cost of intervention.

58 Breit and Elzinga, (1985), p 409.

59 Block and Sidak, (1980), p 1131.

60 Easterbrook, (1985), p 450.

- Savings in Costs of Prosecution

Because deterrent effects depend on the expected value of punishment, various combinations of the detection limit and the magnitude of the sanction can establish the same deterrent effect.[61] This observation has led to the suggestion that high fines could be combined with a low detection level to reduce the costs incurred by a public enforcement system. If people are risk averse, large damages and minimal enforcement efforts can create greater deterrence at a lower cost than an enforcement policy with an equal expected punishment value that combines a higher probability of detection with a lower damage award.[62]

Block and Sidak[63] argue that the major economic argument against the approach of a large fine with a small probability of detection is the possibility of judicial or prosecutorial error. The possibility of such errors introduces a cost of enforcement that cannot be eliminated by setting arbitrarily high penalties. Posner notes that if there is a risk of accidental violation of the law or a chance of legal error, a very severe penalty would deter people from undertaking desirable transactions at the borderline of criminal activity.[64] If these errors occur, public and private enforcers will deter behaviour that causes no social cost. The real burden of such errors would be increased by the risk aversion associated with the high fines.

Polinsky and Shavell indicate that the high fine strategy would not be optimal if the increased risks imposed by the high fine on those subject to the penalty exceeded the additional utility from spending less on enforcement.[65]

A high fine may limit the effect of marginal deterrence - the incentive to substitute less for more serious crimes.[66] Limitations of solvency will also make the cost of collecting fines increase with the size of the fine.[67]

While an approach based on large fines for violations with a low probability of detection may be successful for public enforcement of antitrust, it will not work with private enforcement. As the damages awarded increase, the incentives for private parties to engage in litigation would increase. The trade-off may be utilised if the availability of private damages is limited or the relationship between damage assessment and private recovery is altered.[68]

Easterbrook[69] suggests that the size of the multiplier for damages should depend on the difficulty of detection of the violation (as suggested by the economic approach) and whether the plaintiff is a business rival of the defendant. The second suggestion is based on a presumption that rival firms will tend to use antitrust to reduce competition. He suggests that

---

61 Block and Sidak, (1980), p 1132.

62 ibid, p 1132.

63 ibid, p 1137.

64 Posner, (1986), p 207.

65 Polinsky and Shavell, (1979), p 881.

66 ibid, p 208.

67 ibid, p 209.

68 Block and Sidak, (1980), pp 1133-1134.

69 Easterbrook, (1985), p 448.

the multiplier should in general be at least 1.5 and that when an attempt to hide the offence has been made a multiplier of three or more would be appropriate.

Easterbrook notes that treble damages may be inappropriate when there is a high probability that offending acts will be detected and, if detected, prosecuted; the probability that a reduction in damages would lead consumers to substitute away from the product or take precautions is low; the right to enforcement is concentrated; there is a danger that antitrust enforcement will reduce rather than increase competition; and alternative remedies are available. He notes that all these conditions hold when the plaintiff is a business rival of the defendant claiming predatory or exclusionary conduct.[70] He claims that:

> "firms can create substantial monopoly rents, despite the existence of a competitive structure in the market, if they can impose on rivals costs they do not bear. This is what much regulation is about; some systems exclude entrants, and others raise rivals' costs... Antitrust litigation may help to raise their rivals' costs because the costs of antitrust are asymmetrical. The rational plaintiff challenges something the defendant is doing that the plaintiff does not (or cannot) do. Thus a judgement against the practice raises the defendant's costs but not the plaintiff's - and not just because only the defendant is liable to pay damages. The costs of litigation also are skewed. The plaintiff need only file a complaint and serve demands for discovery. Because most information arguably pertinent to the suit will be in the defendant's possession, the costs of discovery fall predominantly on defendants. If the plaintiff prevails, the defendant must pay the plaintiff's full costs and attorney's fees; a prevailing defendant receives no similar award. The same asymmetries exist when the plaintiffs are consumers. But consumers have little reason to induce courts to condemn hard competition." (1985, pp 460-461)

In suits brought by consumers in the United States, injury is measured as the monopoly overcharge. In suits brought by non-consumers (dealers as well as business rivals), the measure of injury is "lost profits". However, lost profits cannot be a measure of the optimal damages. The plaintiff's accounting profits have nothing to do with the defendant's monopoly rent or the allocative efficiency loss, the two components of optimal damages.[71] No matter who the plaintiff is the appropriate measure of damages is the overcharge times the number of units sold.

- Consumers' Incentives to take Efficient Precautions

The costs associated with monopoly result when consumers switch to alternative products that are more costly than the monopoly output to produce. To the extent that consumers are assured of recovery, they will not switch and less harm will be suffered. Similarly they will not be induced to make expensive investments designed to avoid the monopolist's product.

However, in some circumstances it would be more efficient for consumers to switch to another product than to continue utilising the monopoly product and rely on the enforcement system to obtain redress.

6.2.2 *Enforcers*

To be enforceable and enforced, the antitrust rules adopted must command a broad consensus. Conduct subject to legal prohibition must be more broadly condemned than alternative conduct which a significant body of opinion refuses to condemn. Where there is no overwhelming agreement on the need and role for a particular law, the necessary support for enforcement will not be present.[72]

---

70 ibid, p 459.

71 ibid, p 462.

72 Franks and Baxt, (1988), p 14.

Self-enforcement of the law will be an important supplement to any formal enforcement, particularly where (relatively under-resourced) public enforcement is envisaged. The law should be framed so that it is socially unacceptable to breach it. The social sanctions of fear of scandal or loss of reputation will be important in constraining behaviour.[73] Antitrust policies present some difficulties because in many cases it will not be clear whether or not a particular arrangement contravenes the antitrust laws; the force of moral suasion is therefore reduced. The formal enforcement system will then deal with breakdowns in the informal sanctions or cope with those people who are unaffected by social sanctions but who may respond to the threat of penalties.

If the system is to rely to some extent on self-enforcement there must be a real prospect of action being taken against people who do breach the law.

Galanter notes that the formal legal system resolves only a small fraction of disputes that are brought to its attention and that these are only a small fraction of the disputes that might conceivably be brought to court and only a small proportion of all possible disputes.[74] He notes that in many cases the participants to a dispute are the parties that can most efficiently resolve it:

> "In many instances the participants can devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the case." (1981, p 4)

In Section 3 we noted that many complex contracting arrangements were designed so that contracts were self-enforcing and would not need to rely on the formal legal system.

Galanter notes that the principal contribution of the formal legal system is to provide a background of norms and procedures against which transactions take place. He notes that courts communicate the rules, the possible remedies and the potential costs and difficulty of securing a conviction.[75]

The work of the courts and other enforcement agencies affects not only those immediately subject to it but others as well. Courts provide not only decisions on particular cases but also messages about behaviour. Other individuals' behaviour may change because of interaction with those directly affected or because players have more information on the costs and benefits of different actions.[76]

There is little agreement on whether private or public enforcement of antitrust (or a combination) will result in the socially preferable level of enforcement. Problems can be identified with both enforcement mechanisms.

---

73 ibid, p 14.

74 Galanter, (1981), pp 2-3.

75 ibid, p 6.

76 ibid, p 13.

- Optimal Enforcement Using Private or Public Enforcers

Elzinga and Breit note that public enforcement has the advantage of separating incentives for enforcement from the penalty itself. The amount of the fine can be altered without affecting the amount of resources going into the detection and conviction of violators.[77]

Where the damages set are inappropriately scaled, perverse incentive effects will be created for private enforcers. For example under the system of treble damages in the United States a customer may strategically seek out situations in which injury is suffered so that it can obtain treble damages. The existence of perverse incentives will occur more frequently if the probability of conviction is high relative to the damage sustained. In the case of a merger where the violation is not concealable, damages should be limited to a multiplier of one.

- Incentives for Enforcement

The incentives for private enforcers to pursue antitrust cases are stronger than for public agencies because private individuals' personal wealth is directly at stake in an antitrust case. Vickers and Hay note that there is a strong case for allowing private actions. They cite four reasons why private action should be allowed:

> "The first is that parties injured by breaches of competition law ought to be able to seek compensation for their losses. At present they can only hope (and lobby?) that the public authorities intervene to stop the damaging practice. Secondly, private parties in some cases have superior information about behaviour that possibly violates competition laws. If private actions were allowed, they would have the incentive and opportunity to use that information, and the public would benefit. Thirdly, the process for selecting cases would be less subject to political (and generally non-economic) influence. Fourthly, there is the prospect that court judgements on private actions would lead to the development of case law, and hence to the greater predictability of competition policy." (1987, p 53)

However, Posner[78] claims that private enforcers "cannot be relied upon to exercise appropriate self-restraint", and that in the United States private antitrust has "expanded by too much". He argues that a public agency is at least forced by tight budget constraints to be selective in the cases it pursues.

Scherer reinforces this claim by noting[79] that where multiple damages apply, private individuals may be tempted to file "nuisance suits" in the hope of achieving an out of court settlement. This strategy may be successful if defendants are not prepared to accept the costs and risks associated with litigation; they may settle simply to avoid litigation. The likelihood of such litigation is lessened if the multiple damages are appropriately scaled and if the costs borne by unsuccessful plaintiffs more closely reflect the social costs of the enforcement system.

Breit and Elzinga[80] observe that private enforcers may use antitrust opportunistically to challenge vertical contracts between manufacturers and distributors that had been entered into voluntarily. The costs of such opportunistic behaviour go far beyond the court cases involved. Manufacturers are forced to seek ways in which the opportunity for such behaviour is minimised.

---

77 Breit and Elzinga, (1985), p 440.

78 Posner, (1976), p 228.

79 Scherer, (1980), p 504.

80 Breit and Elzinga, (1985), p 434.

While the problem of inappropriate enforcement by private enforcers is of concern, it is debatable whether the incentives facing public agencies better align their actions with the objective of maximising efficiency. The most expensive and long-running case in the United States was the monopolisation case against IBM brought by the US Justice Department's Antitrust Division. The case was eventually dismissed by Baxter in 1982 who stated it was "without merit". Fisher argues that the "fiasco" of the IBM case was due in part to the unsatisfactory economic analysis undertaken by the government's lawyers.[81]

Posner notes that it is difficult to determine whether too many or too few resources are being devoted to public enforcement of the law. Regulators lack objective criteria against which they can measure the efficiency of regulation. In the absence of such criteria, it is difficult to design a system of rewards and sanctions for members of the agency. The performance of regulators is extremely difficult to evaluate which makes it possible for them to "bend their regulatory duties to the service of personal interest".[82]

Stigler[83] suggests that, as a reasonable assumption, regulators act to (a) retain their jobs and (b) obtain greater appropriations for their agency as a way of increasing personal power (and frequently remuneration as well). Posner observes that the self-interest of such individuals would tend to dictate the avoidance of controversy and the conciliation of well-organised interests. He notes that such policies will be inconsistent with the pursuit of consumer interests.[84]

In the United States, the majority of Commissioners leaving the FTC go into private practice. Posner[85] notes that the pursuit of consumer interest would not enhance their prospects in such work. Consumers are unlikely to reward them for pursuing their interest whereas the enmity of the organised groups such as trade associations and commercial interests that might result from enthusiastic pursuit of consumer interests may do some later harm while making existing tenure at the Commission more difficult. It follows that Commissioners and staff may not be rewarded by prosecuting cases that will improve overall welfare.

Public enforcement may provide opportunities for bribery and corruption because the return to the enforcer from enforcement is likely to be less than the offender's potential penalty. However, a similar situation may arise if an attempt is made to ensure that private action does not result in over-enforcement (e.g. through a tax).[86] Although a private enforcer is compensated on a piece rate basis, and the public one is not, the private enforcer will be more sensitive to the costs of unsuccessful prosecution. This may result in more careful assessment of whether or[87] not a person is innocent (since the resources devoted to prosecuting innocent people are less likely to yield benefits to the enforcer).[88]

81 Fisher, McGowan and Greenwood, (1983), p 1.

82 Posner, (1969), p 85.

83 quoted in Posner, (1969).

84 Posner, (1969), pp 85-86.

85 ibid, p.86.

86 Posner, (1986), p 561.

87

88 ibid, p 562.

- Spillover Effects

The possible difficulty of administering private action when many victims are affected by a small amount is sometimes suggested as constituting a case for government enforcement.[89] The costs of enforcement may be so high, relative to the value of the claim held by a private individual with the right to prosecute, that fewer resources would be devoted to enforcement than if the claims were more concentrated. The class action and middleman suit are devices for overcoming this problem. Franks and Baxt note that under the new High Court rules in New Zealand the procedural difficulties in bringing class actions have been significantly reduced.[90] The use of contingent fees, in which a lawyer's fees are contingent on a successful outcome, may be used as a device to facilitate private action.[91]

Easterbrook notes that assigning rights to a single enforcer may overcome the problem of aggregating claims although it will give rise to others. A single enforcer may have difficulty inducing victims to contribute their information. Unless the enforcer compensates the victims, their incentives may become skewed so that they tend to take excess precautions. If the enforcer compensates all victims it will not obtain full value for its efforts. The more broadly the rights to prosecution are spread, the less likely are individuals to buy substitute products for the monopolist's output and the greater are the incentives for each victim to produce the information it possesses. On the other hand, the benefits that individual enforcers obtain for their efforts will be less.[92] Where the single enforcer is a public body, the problem of appropriate incentives described above may arise.

If the function of legal systems were merely to settle disputes, it would be appropriate to impose the entire costs on the disputants. But because decisions may shape the behaviour of other litigants, the social benefits may outweigh the private benefits. Private arbitrators rarely write opinions as do the public judges. The value of such opinions generally goes to people other than the current disputants.[93]

- Courts or an Administrative Body?

An administrative agency may have a comparative advantage over a court in articulating, elaborating and applying at least some aspects of antitrust policy. A coherent body of law may be more likely to emerge from a single tribunal specialised in antitrust law than from general courts especially if the tribunal is not limited to arbitrating disputes but can choose cases and maybe the timing of litigation. It can be reasonably flexible in how it hears cases.[94]

However, judges can choose to specialise in commercial and antitrust cases and administrative processes that are relatively flexible have been adopted by the Courts.[95]

---

89 Posner, (1976), p 227.

90 Franks and Baxt, (1988), p 16.

91 ibid, p 16.

92 Easterbrook, (1985), pp 448-454.

93 Posner, (1986), p 493.

94 Posner, (1969), p 51.

95 ibid, p 52.

An administrative agency that both decides which cases that should be brought and then tries them may be subject to conflicts of interest. Posner notes:

> "It is too much to expect men of ordinary character and competence to be able to judge impartially in cases that they are responsible for having instituted in the first place. An agency that dismissed many of the complaints that it issued would stand condemned of having squandered the taxpayer's money on meritless causes." (1969, p 53)

A specialist agency faces incentives to increases its jurisdiction and importance by extending its reach into cases that do not merit its consideration. The Courts on the other hand are likely to be less predisposed to an excessively activist role. Unlike regulatory agencies they will not have the same tendency to want to justify their existence by being seen to be "doing something" and are not constrained in the type of case they hear. A reduction in antitrust cases would not significantly affect their overall workload or status.

6.2.3 *Procedure*

Traditional court proceedings are not well suited to hearing complex economic arguments and for making balanced decisions on highly technical issues. The sequencing whereby the plaintiff, the defendant and then the plaintiff again each argue their cases means that all of the evidence bearing on a particular issue is not presented all at once. Significant periods of time may elapse between the plaintiff putting the case and the defendant giving an alternative version of events.[96] If delay is advantageous to one party or the other, proceedings can be prolonged by challenging all the evidence and testimony of expert witness. Many judges trying antitrust cases do not have a sufficient understanding of economics. The adversary process is designed and best suited for reaching an "either/or" decision, e.g. whether the defendant is guilty or not. It is not as effective in considering matters along a continuum or in weighing many conflicting matters to reach a decision as to whether, on balance, the matter at issue best serves the public interest.[97] A regulatory agency may be able to adopt a more flexible approach to hearing evidence in an antitrust case.

Vickers and Hay note that in the United Kingdom several branches of law have developed relatively quickly with specialist lawyers and judges acquiring the necessary skills. They cite the Restrictive Practices Court as an example.[98] However, it is worth noting that the United Kingdom system is becoming more reliant on administrative procedures.

One of the difficulties with antitrust cases is that organisational economics is not an exact science. Business decisions are based on estimates of possible efficiencies that are often uncertain, even intuitive, and would not satisfy legal standards of proof. Schmalensee notes that:

> "A rule of law that permits only mergers that can be proven to increase welfare will permit no mergers, while a rule that bars only mergers that can be proven to decrease welfare will stop no mergers."

He goes on to observe that:

> "the best one can hope for in practice is a merger policy that makes few major blunders and operates with enough speed and predictability so as not to become a major source of cost and uncertainty. Such a policy must necessarily rely on presumptions and shortcuts that reflect the current state of economic knowledge and belief." (1987a, pp 42-43)

---

96 Posner, (1976), p 233.

97 Scherer, (1980), p 510.

98 Vickers and Hay, (1987), p 53.

Scherer suggests that because of the difficulties of using the traditional court system, a special antitrust court could be established in which procedures were streamlined. Rules of evidence suitable to economic investigations should be adopted. Judges and laypersons involved would be qualified in economics.[99] Posner suggests[100] that trial testimony should consist of factual narrative rather than the usual approach of raw data of testimony and documents. The presentation of documents and testimony should be limited to the few issues that are in dispute.

99 Scherer, (1980), p 512.

100 Posner, (1976), p 234.

Section 7 Empirical Evidence on the Costs of Monopoly and the Potential Costs of Intervention

This section examines the empirical evidence on the cost that arises from monopoly. It concludes that the costs are "modest" even when they are assessed relative to the unattainable benchmark set by the perfect competition model. The costs associated with government antitrust interventions are then examined. The conclusion is that significant costs will be imposed by government intervention; in many cases these will outweigh the potential gains from intervention.

7.1 Empirical Evidence on the Costs of Monopoly

A number of situations have been identified in which private arrangements within the general property rights framework may not achieve the most efficient outcome possible. Economists have attempted to assess the potential magnitude of the costs of the possible shortfall in community welfare. Such assessments can give an indication of the potential gains from further government intervention (although they do not take into account the costs that would be incurred by intervention).

The cost associated with "monopoly" has traditionally been assessed using the monopoly diagram presented in Appendix I. A number of potential costs may result from monopoly. The first cost is the allocative efficiency loss associated with producing output at a level lower than the socially optimal level (the welfare loss triangle). The lack of constraints on the management of a monopoly firm may result in less pressure to produce output efficiently. A third possible monopoly cost is that people will engage in wasteful rent-seeking activity aimed at achieving a position in which supra-normal profits might be obtained. Rent-seeking can involve direct lobbying of the government for special privileges or private action such as the suggested "over-production" of goods or services (e.g. advertising) that will help secure a monopoly position. Higher cost production or rent-seeking activity may dissipate some or all of the "monopoly rents".

Offsetting benefits that should be taken into account when assessing monopoly situations include lower production costs because of economies of scale, organisational economies, the minimisation of transaction costs and dynamic incentive effects. Because cost savings apply to all units of output produced, a small reduction in cost can quickly outweigh any deadweight loss from the possession of "market power".

The major limitation with the empirical studies is that they take the "competitive level" identified in the diagram in Appendix I as an achievable benchmark and assume that any deviation from this standard is a cost of monopoly. However, as noted above, if no alternative institutional arrangement can be identified that will improve on the "problem" identified, then there is no problem or cost. Nearly all firms are differentiated sellers. No alternative arrangement has yet been identified which would improve on the outcome achieved in that situation. Little is to be gained by observing that the real world does not measure up to utopia.

The traditional approach does not allow for the positive role of profits in a dynamic economy and the fact that profits arise from sources other than monopoly. The estimates assume that the economy is in a long run equilibrium. However, some of the excess profits calculated would be expected to be competed away over time. Littlechild points out that:

> "[T]he empirical calculations made by all these authors are unable to distinguish the source and nature of observed profit rates, nor are they able to estimate their duration... In the long-run equilibrium model, all profits necessarily imply a welfare loss. There is no scope for profits which might be harmless, let alone any scope for profits to play a socially beneficial role in the operation of the economy. Thus the very choice of a long-run equilibrium framework within which to analyse monopoly misinterprets the nature

of profits, overestimates the extent of monopoly power, and thereby overestimates the social cost of monopoly." (emphasis in the original, 1981, p 356)

Because the estimates are essentially static they ignore any possible dynamic gains that might arise because of monopoly. The attainment of monopoly may be necessary to induce research into valuable new products. It may be necessary to induce firms to invest in reputation, thereby saving on consumer search costs. A firm may not undertake a risky sunk cost investment if it does not expect it will be able to price above marginal cost. Many of the costs measured will be the result of inappropriately high government-imposed barriers to market entry and not the failure of private arrangements within the general property rights framework. If this fact is not taken into account, the general case for intervention will be overstated. Overall, the measurements of the cost of monopoly that adopt the competitive level of output as the benchmark will result in a significant overstatement of the potential gains from antitrust intervention.

Harberger[101] pioneered the measurement of the (static) deadweight loss arising from monopoly in manufacturing industries using the simple competition model as the benchmark. He studied 73 manufacturing industries which generated 45 percent of all United States manufacturing output over the period 1924-28. He assumed that the deviation of an individual company's profits from the overall average was an estimate of the monopoly price distortion. The further assumption was made that demand had an elasticity of one in all cases. Using this information, pro-rated to cover all of manufacturing, Harberger found that the welfare losses of monopoly were probably as low as 0.1 percent of GDP. Support for his conclusions was provided by Worcester adopting a similar benchmark. He used Fortune 500 company data over 14 years to estimate a welfare loss of the order of 0.3 percent of GNP.

Harberger's estimate would be expected to underestimate the overall cost of monopoly to the economy for a number of reasons. It was limited to manufacturing industries which constituted around a quarter of total United States GNP. Distortions could be expected in other sectors of the economy as well. Harberger assumed that the average profit earned was equal to the "normal competitive" profit rate. However, the average profits would already include an element of monopoly profit. The profit data used by Harberger were generally aggregated which would tend to produce a downwards bias in deadweight loss estimates. Some monopoly gains would have been capitalised and included in costs when, for example, assets were sold. On the other hand, Harberger's study would also have captured examples where profits were high for reasons other than monopoly.

Kamerschen (1966) and Cowling and Mueller also measured the cost of monopoly assuming that the "competitive" level of output is an alternative achievable possibility. However, instead of adopting Harberger's assessment of an elasticity of demand of one, they attempted to estimate the elasticities for individual companies. Their estimates of elasticities were much higher and therefore their estimates of the deadweight loss were significantly higher than Harberger's. They estimated the welfare loss triangle to be approximately equal to half the level of profits. They calculated allocative efficiency losses in the range of 4 to 7 percent of GDP.

Littlechild[102] notes that Cowling and Mueller's assumption about the relationship between profits and the welfare loss triangle will overstate the costs of monopoly. Many firms make extensive use of price discrimination either directly or through multi-part tariffs, tie-in sales, discounts and so on. Price discrimination may lead to increased output, a reduced welfare loss and a welfare loss triangle that is less than half of pre-tax profits. Scherer[103]

---

101 This discussion draws on Scherer, (1980), pp 459-474.

102 Littlechild, (1981), pp 353.

103 Scherer, (1980), p 462.

questions the elasticity assumptions adopted by Cowling and Mueller. He notes that the accounting data used by Cowling and Mueller give rise to much larger elasticities and hence much larger welfare loss estimates than the Harberger method. He suggests the estimates produced should be regarded with scepticism. Littlechild[103] notes that a significant distortion is introduced by the assumption that the economy is in long-run equilibrium. One result is that profits that arise through "good luck" are assumed to be monopoly profits.

Efforts to obtain a monopoly position and protect it against others may involve costs. At an extreme it is possible that all of the rents may be dissipated in this manner. Efforts spent in lobbying the government to erect barriers to entry can impose costs. Private efforts to gain or protect a monopoly position may involve similar costs.

Cowling and Mueller assume that all advertising is a social cost in deriving an overall calculation of the social cost of monopoly at 13 percent of United States GNP. They admit that such a stance "takes the extreme view of advertising as merely an instrument for securing market power. To the extent that advertising provides useful information to consumers, this merely overstates the cost of monopoly".[104] Littlechild notes that "to assume that most advertising is pure waste arguably implies a rather condescending view of ordinary consumers".[105]

Scherer suggests, for example, that where barriers or agreements between competitors prevent price competition, excessive amounts will be spent on non-price rivalry by way of advertising, promotional expenditure, product differentiation (suggested by Scherer at about 1 percent of GNP) and in some cases the provision of excess capacity. Presumably, artificial barriers are preventing the entry of new players into the market so that competition on non-price grounds occurs. Otherwise, a new organisation could be expected to enter the market and compete on the basis of prices.

Most estimates ignore the impact of monopoly behaviour at intermediate stages in both labour and product markets. Scherer[106] notes that wage levels tend to be higher in concentrated industries and that if these are not offset by higher productivity there would be further resource misallocations in the labour and product markets. He suggests that the size of the effect is too conjectural to permit an informed guess as to its extent. Generally such effects would argue for an upward adjustment of the monopoly cost estimate. Heldman et al. have estimated the social costs of labour sector regulation in the United States to be at least $170 billion annually.[107]

"Second best" considerations are also generally ignored. Second best considerations take into account the possibility that moving one market closer to the "first best" perfect competition situation may not improve welfare when other markets are "imperfect". It is difficult to determine in which direction the neglect of second best considerations would bias estimates.

Because it is not possible to clearly define a benchmark against which the cost of monopoly can be accurately measured, it is not possible to quantify the cost of monopoly. The studies that have been undertaken measure the cost of monopoly against the unattainable ideal of the perfect competition model. As a result, these estimates will be at the high end of likely costs.

---

103 Littlechild, (1981), p 355-356.

104 Cowling and Mueller, (1978), p 733.

105 Littlechild, (1981), p 353.

106 Scherer, (1980), p 463.

107 Heldman et al., (1981), p 121

Scherer, an economist who advocates an active antitrust policy, sums up the empirical evidence on the allocative inefficiency of monopoly in the following manner:

> "[i]t appears that the deadweight welfare loss attributable to monopolistic resource misallocation in the United States lies somewhere between 0.5 and 2 percent of gross national product, with estimates nearer the lower bound inspiring more confidence than those on the high side." (1980, p 464)

He notes that in terms of the overall costs of monopoly:

> "[t]he most that can be said with reasonable confidence is that the social costs directly ascribable to monopoly power are modest." (1980, p 470)

7.2 Potential Costs of Government Intervention

A number of costs are imposed by antitrust intervention in the economy. The most obvious cost is the direct cost of administering and complying with antitrust laws. In the New Zealand context these costs include the human resources used in New Zealand's growing antitrust industry and the considerable amount of management time taken in complying with the Commerce Act. Antitrust laws also become a weapon in the competitive process. Firms may strategically use antitrust policy to raise their rivals' costs or lower their efficiency by challenging particular contractual arrangements or attempting to block mergers or takeovers. Similarly, under-performing management teams can use antitrust law to block takeovers designed to replace them, thereby lowering the effectiveness of the market for corporate control. Government intervention is inherently uncertain. This uncertainty and attempts to manage it involve further economic costs. Finally, but perhaps most importantly, antitrust laws inevitably deter or preclude some efficiency-enhancing practices. These problems are compounded by the difficulties in aligning the actions of self-interested regulators with the wider community interest.

Easterbrook[108] notes that in the United States judges have generally regarded business practices with suspicion. Where alternative ways of organising transactions existed, new methods that appeared to achieve the same outcome were viewed unfavourably. As a result, many practices were condemned which, with improved economic understanding, do not generally raise concerns. For example, franchise arrangements are now widely recognised as enhancing efficiency. As noted earlier, exclusive dealing may be used as a means of protecting manufacturers' investments in advertising and other promotional and brand-enhancing activities. In the New Zealand context, Fisher and Paykel, for example, claim that the development of a skilled and efficient dealer network has been a key aspect of establishing a reputation for high quality products and good retail and after-sales service.

Because of the difficulty of distinguishing harmful from efficient practices, the definition and administration of the law must be uncertain. The uncertainty created can generate significant costs. Firms will be deterred from taking over rivals that are badly managed because of doubt that they would be approved by the antitrust authorities. Firms may be deterred from adopting innovative business practices even though they are designed to lower costs or improve the quality of their output.

Antitrust rules affect the constraints within which economic activity takes place. Market participants competing for a greater share of resources will use antitrust laws to advance their own interests. The direct misuse of courts and governmental agencies is an effective means of adversely affecting competitors. A feature of major New Zealand Commerce Commission decisions to date has been the prominent role of competitors in opposing merger proposals and

---

108 Easterbrook, (1984), p 4.

attacking particular contractual arrangements. For example, the most active opponents of the Goodman Fielder/Wattie merger were competitors to the merger parties in the flour and bread markets.

The direct costs involved in litigation and the opportunity costs of executive time can be very high. The absolute amount spent on litigation by two firms may be the same, but the effect may be more severe for a small firm and therefore an effective method of preventing market entry.[109] Such use of antitrust laws may be to the detriment of consumers and economic efficiency. Improved contracting arrangements or a merger that enhances efficiency will reduce the success of the firm's competitors in their struggle for market share and profitability. In many cases their response is to accuse the more efficient firm of predatory practices. Antitrust action is frequently directed against firms that have been very successful in meeting customer needs. Baumol and Ordover note:

> "Whenever a competitor becomes too successful or too efficient, whenever his competition threatens to become sufficiently effective to disturb the quiet and easy life his rival is leading, the latter will be tempted to sue on the grounds that the competition is 'unfair'. Every successful enterprise comes to expect almost as a routine phenomenon that it will sooner or later find itself the defendant in a multiplicity of cases. It is an enchanted topsy-turvy world in which vigorous competition is made to seem anticompetitive and in which 'fair competition' comes to mean no competition at all." (1983, p 252)

They go on to note the following:

> "There is a specter that haunts our antitrust institutions. Its threat is that, far from serving as the bulwark of competition, these institutions will become the most powerful instrument in the hands of those who wish to subvert it. More than that, it threatens to draw great quantities of resources into the struggle to prevent competition, thereby more than offsetting the contributions to economic efficiency promised by antitrust activities. This is a specter that may well dwarf any other source of concern about the antitrust process."

Finally:

> "Antitrust, whose objective is the preservation of competition, by its very nature lends itself to use as a means to undermine effective competition. This is not merely ironic. It is very dangerous for the workings of our economy." (1983, p 247)

The existence of antitrust laws provides the incentives and means for interest groups to capture and change the regulatory process to advance their own interests. Consumers generally have little incentive to organise themselves to influence antitrust policy because of the costs of forming a cohesive group and the spillover of any benefits to non-organised groups.

In the United States, small businesses, which represent a significant block of voting power, have had considerable success in capturing the regulatory process and protecting themselves from more efficient large companies. The courts have in some cases ruled explicitly to protect small competitors at the expense of consumers.

The experience in the United States has been that the more efficient and successful a firm is in attracting consumers and winning market share, the more exposed it becomes to regulatory interference and the strategic use of antitrust. The IBM case is one of the more extreme examples of this process.

---

109 Bork, (1978), p 159 and p 252.

The incentives facing the regulatory agency may do little to encourage economic efficiency. The more interventionist the regime is, the greater the power and influence of the regulatory body. Other participants in the antitrust industry have incentives to encourage antitrust activism with little regard to the efficiency of resource use.

Lawyers and economists are amongst the beneficiaries of complex and extensive antitrust laws. Indicative fees in the major merger cases heard in New Zealand are: Goodman Fielder/Wattie in the Goodman Fielder/Wattie merger - $1 million; Fletcher Challenge in the Fletcher Challenge/NZ Forest Products merger proposal - $600,000; Brierley Investments in the Brierley/Petrocorp merger proposal - $200,000.[110] In each of these cases substantial legal and economic fees were also incurred by the other parties involved. In the Fletcher Challenge/NZ Forest Products merger proposal, for example, Fletcher Challenge's written submissions were matched by submissions of similar length and detail from NZ Forest Products.

The Fletcher Challenge Limited/NZ Forest Product Limited merger provided a classic example of the use of the antitrust laws to oppose "hostile" takeover bids. NZ Forest Products' senior executives actively opposed the merger proposal and filed numerous lengthy submissions outlining its "anti-competitive" effects. This active opposition occurred even though the NZ Forest Products share price rose by 46 percent over the four week period from the first newspaper speculation of a takeover bid through to the second day of trading following the announcement of the bid.[111]

The overall effect of antitrust laws has often been the protection of existing market structures at the expense of new ones and existing firms over new ones. Inefficient firms have been protected at the expense of more efficient ones.

Empirical investigations[112] find that proxies of welfare loss (or potential welfare gains through intervention) explain only a small part of antitrust activity in the United States, a conclusion that would be consistent with propositions about the strategic use of antitrust. The size of the organisation appears to have some explanatory power in relation to antitrust, confirming the tendency to "beat up the winners"[113]. Antitrust activity, in other words, frequently focuses on firms that have been successful in the competitive process. The conclusion from the studies is that much of the explanation of antitrust activity is not to be found by reference to the conventional economic analysis.

Antitrust is a growth industry involving lawyers, economists, government bureaucrats, corporate executives and academics. Reich[114] has estimated the amount of antitrust sold in the United States at around $2.5 billion in 1979. The calculations explicitly exclude business executive time spent on antitrust matters, antitrust instruction in law schools and corporations and lobbying efforts to obtain antitrust exemptions. Most Commerce Commission cases in New Zealand tend to involve a significant time input from senior executives in coordinating other staff (who gather and process information), preparing applications and submissions, briefing lawyers and economic consultants and meeting with the Commission and its staff. The input of senior executives in some recent New Zealand has been estimated as follows: Goodman Fielder

---

110 Jennings and Begg, (1988), p 68.

111 ibid, p 70.

112 See for example Long, Schramm and Tollison, (1973) and Siefried, (1975).

113 Schmalensee, (1987), p 61.

114 Reich, (1980), p 1068.

Wattie - two person years; Fletcher Challenge - 14 person months; Fisher and Paykel - 16 person months (to date); Brierley Investments - three person months.[115]

Most importantly, the figures do not include the costs of forgone efficiencies or the delay in the realisation of efficiency benefits. Such effects are likely to outweigh the direct costs by a significant amount. Goodman Fielder Wattie and independent analysts have estimated the first full year synergies arising from the Goodman Fielder/Wattie merger at approximately A$10 million. The time required to achieve Commerce Act approval effectively meant that the efficiency gains for one entire year were lost. The time required to achieve consent also meant that decisions regarding several major projects were delayed by 18 months or more.[116]

7.3 Summary

- The empirical costs of monopoly have been assessed as "modest".
- Antitrust intervention will incur costs. Rules that prevent mergers and complex contracting arrangements inevitably prevent transactions that would improve efficiency. There is no guarantee that these costs will not outweigh any possible benefits from the intervention.

---

115 Jennings and Begg, 1988, p 69.

116 ibid, p 69.

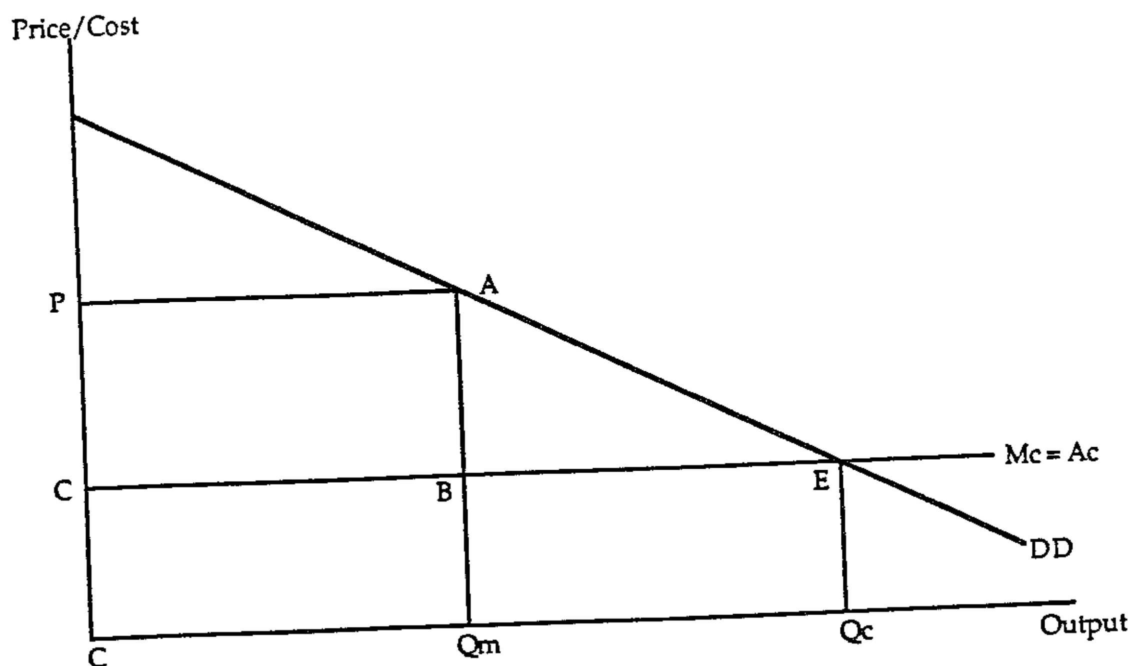
APPENDIX I

The Standard Monopoly Model

The description of the monopoly problem assumes that transaction costs force the monopolist to charge a single price and prevent the monopolist and potential customers negotiating for an increase in output.

A monopoly producer will not lose all of its customers if it raises its prices. It can therefore change the price at which it sells its output by changing the amount of output it offers for sale. If the monopolist reduces output below the competitive level, the market price will rise. The monopolist's total costs would be lower because less output is produced. Total revenue (i.e. price times the amount of output produced) will increase if the proportional increase in price outweighs the proportion by which output is reduced. When the price increase is greater than the reduction in output, the price increase will be profitable to the firm. Its total revenue will be higher and costs lower, so the difference between revenue and cost (profit) will be higher. The monopolist will increase prices to the point at which any further increase would reduce total revenues by more than the reduction in total cost resulting from the smaller quantity produced.

These results are shown in the accompanying diagram. Assume that the long-run average costs are constant for both firm and industry and are represented by the line Mc = Ac (marginal cost equals average cost). The "perfectly competitive" output would be at Qc where Mc intersects the demand curve DD. If a monopolist were substituted, profits would be maximised by producing Qm at price P. The monopoly profit (sometimes termed "monopoly rent") would be represented by the rectangle ABCP. The loss of consumers' surplus is measured by the trapezoid AECP. The part of this area represented by ABCP is, however, not destroyed welfare but simply a transfer of wealth from consumers to the monopolist. The net loss to society as a whole from the monopoly is given by the "welfare loss triangle" ABE, sometimes described as a loss of "allocative efficiency".



APPENDIX II

Property Rights and Transaction Costs Constraints

This section notes that different property right constraints will produce different economic outcomes. Society must choose those constraints that best suit its purpose.

Constraints that allow a society to maximise the gains from transactions will produce the greatest benefits in terms of material and non-material well-being from scarce resources. Typically, enabling a maximisation of the gains from transactions requires incentive structures which encourage minimising the production and transaction costs involved in enabling members of society to obtain the material and non-material benefits they seek. The role of the government in shaping the incentives through the system of property (and contractual) rights is discussed in this section.

1.1 Zero Transaction Costs World

Transaction costs are critical for understanding the role of the government and antitrust policy. Such costs limit the ability of individuals to allocate scarce resources to their most highly valued uses. Transaction costs include the cost of obtaining information about alternatives; the uncertainty of outcomes; and the cost of negotiating, policing and enforcing the explicit or implicit contracts that underlie all transactions between individuals and organisations. Defining and enforcing rights to resources is costly. Costs are incurred in coping with the fact that people are not able to process unlimited amounts of information. People can be "opportunistic" and may renege on understandings or agreements with others. Uncertainty and information costs make it impossible to foresee and contract for all eventualities. Costs are incurred in structuring arrangements to minimise the adverse effects of opportunism. Real resources are expended in attempts to gain informational advantages over others and to establish strategic advantage over other parties to contracts. Resources are wasted in lobbying governments for special rights.

In the absence of transaction costs, resources would be allocated to yield the highest return to society regardless of the nature of property rights or institutional arrangements. All imaginable gains from trade would be realised.

People could negotiate costlessly with one another to obtain the highest value from resources. All people affected by the use of a resource could be identified and contracted with. Resource use decisions would, by definition, fully reflect the costs and benefits to all individuals of alternative resource uses. Alternatively, in the absence of transaction costs, a central planner could perfectly allocate resources to their best uses.[117] Information about preferences, production technology and so on would be obtained costlessly by the central planner and goods could be allocated in such a way that the highest possible level of welfare was obtained.

In the absence of transaction costs, a factory and its neighbours could get together to negotiate the optimal level of pollution. A factory could compensate neighbours for the right to pollute air. Alternatively, neighbours could pay the factory to restrict pollution if they valued clean air more than the factory valued the right to pollute. Whatever the initial allocation of

117 Cheung, (1986), p 37.

rights, the same quality of air would be obtained through negotiation: it would be determined by the relative value of the clean air to neighbours and the value of the right to pollute to the factory. A perfectly altruistic central planner would set allowed pollution at the same level. The initial allocation of rights would affect income distribution, and may therefore have second-order effects on resource allocation.

The monopoly "problem" would not exist if transaction costs were zero. There would be no need for antitrust intervention. The potential gains from trade associated with monopoly could be realised by negotiation between the monopolist and the consumer. For example, perfect price discrimination would allow the monopolist to increase output to the "competitive" level. Alternatively a central planner could costlessly determine the optimal level of output.

This theoretical world of zero transaction costs does not exist. A model that assumes zero transaction costs is of little value for policy analysis. Demsetz notes that models that assume a zero transaction cost benchmark risk committing three logical fallacies. He describes these as "the fallacy of the free lunch"; "the grass is always greener fallacy"; and the "people could be different" fallacy. The fallacy of the free lunch involves the idea that reality could be improved on by bringing outcomes nearer to the perfect competition model; the grass is always greener fallacy is based on the mistaken assumption that governments can costlessly "improve" on the outcomes produced by the market; the people could be different fallacy involves inferring inefficiency from unavoidable characteristics of people such as risk aversion, limited knowledge or opportunism. The failure of the models to reflect reality is a case of "model failure" rather than "market failure".[118]

1.2 The Impact of Transaction Costs

Transaction costs make it difficult and costly to identify and negotiate complete contracts between all affected parties. Their existence means that it is not worthwhile to take into account the effect of resource use on all people (the costs of negotiating outweigh any potential benefits).

Costly information makes peoples' preferences difficult to assess. For example, people have incentives to overstate the adverse impact they might suffer from the attenuation of their rights. Conflicts over access to rights may occur. In the absence of a government with a monopoly on coercive powers, the law of the jungle may prevail.

In the circumstances described, potentially beneficial transactions do not take place because the costs (including the transaction costs) of undertaking them outweigh any expected benefits. For example, a monopolist will not be able to perfectly identify all those consumers who would be willing to buy additional output if the price were lower. A factory would experience difficulty in identifying and compensating all people who might be affected by pollution. Similarly, people who wanted a lower level of pollution would experience difficulties in organising and deciding on the amounts they would be prepared to pay the factory to reduce pollution.

Transaction costs will simultaneously influence the costs and benefits of different property rights arrangements. For example, before the invention of barbed wire fencing of land was costly and smooth wire ineffective in holding cattle. Fencing was not used as a method of enforcing private property rights. The introduction of barbed wire greatly reduced the cost of enclosing one's land, and it was then used to delineate private property.[119]

Within the constraints of the property rights system, private arrangements will develop to minimise the costs of undertaking mutually beneficial transactions. The existence of

118 Toumanoff, (1984), p 529.

119 Anderson and Hill, (1975), p 172.

transaction costs can explain arrangements that were previously believed to be part of the "monopoly problem".

1.3 The Property Rights Constraint

The Government may reduce (or increase) transaction costs by the way it defines, assigns and modifies the rights to resources ("property rights"), including the right to contract. The government can in some circumstances change the constraints so that the sum of production and transaction costs is reduced. It can therefore facilitate welfare-enhancing transactions. However, if intervention costs more than the value created by the additional transactions it generates, society will be worse off as a result of government action.

Governments can potentially improve on the private situation because they face different constraints from private individuals. Cheung notes:

> "Behaviour differs [between government and private transactors] because policy-makers and private individuals confront different constraints, and their options of choice differ accordingly... Economic analysis has thus far failed to predict the circumstances under which government action will incur lower (or higher) costs than those resulting from private contracting." (1978, p 48)

Generally government intervention takes the form of defining and assigning individual rights and allowing these to constrain private activity. The government then enforces the rights and may have a role in resolving disputes as they arise. Alternatively, the government may specify rights in a way that requires its ongoing involvement in establishing limits and monitoring compliance. For example, the government may subject a resource owner to price control. The government or its agents will generally need to be actively involved in determining the allowable level of prices and ensuring compliance with such requirements.

The existence of transaction costs means that the initial assignment of property rights may have an impact on outcomes. If transaction costs are high, property rights may not be reallocated even where they would be more highly valued by someone else. If the right is assigned to the individual who values it most highly, welfare may be improved (if the transaction costs of making the change are not higher than the costs which prevented the transaction in the first place).

A system of property rights defines the terms on which individuals have access to resources and resolves (as far as possible) problems created by interdependencies. Because one person's use of a resource affects other people either beneficially or adversely and negotiation is costly, the definition of a system of rights is fundamental to reducing the transaction costs of exchange. For each resource, the system of rights needs to define:

- what limits there are on the extent to which the use of the resource can impose costs and benefits on others without compensation being paid (and similarly the extent to which others' rights will attenuate the rights in question);
- given the limits that attach to the rights, who has the right to decide the use of the resource;
- who has the right to income from the resource;
- the extent to which the rights to use the resource and retain income from it might be traded.

Created and enforced by the government, property rights define a set of rules and economic and social relationships for the use of goods. They determine the extent to which the owner is able to exclude others from the use of the resource and impose costs (and benefits) on others without requiring the owner to explicitly negotiate with them. Property rights save on the

costs of negotiating with all affected parties to take into account the impact of resource use. Once defined, property rights can be reallocated, and in some cases altered, through market transactions, by the government process of legally specifying and reassigning rights, or by theft.

Property rights will affect the incentives facing individuals and determine how efficiently resources are used. Different sets of rights and the accuracy with which these can be specified will produce different outcomes in terms of equity and efficiency.

The more precise the definition of property rights the less will be the uncertainty as to what owners of rights can or cannot do with their resources. Well-specified property rights save on the transaction costs of determining how the resources may be used. They save on identifying and negotiating with all people who are affected by the use of a resource. Generally, the limitations on rights attaching to resources should be restricted to situations in which the costs of negotiating with those affected by the resource use are high and therefore may be prevented. The restrictions should be designed to direct the use of the resource to the most efficient alternative.

For example, a maximum allowable level of pollution may attach to the right to build a factory in recognition of the difficulties that would be experienced by neighbours cooperating to obtain a reduction in the pollution. The imposition of such a restriction on the factory imposes harm on that factory; it will be more costly for it to produce output, for example. Such a restriction can be justified only if the benefits to neighbours from the reduced pollution outweigh the costs imposed on the factory and incurred by the government in regulating.

1.4 "Private" Property Rights

Property rights are described as "private" when the owner has, within defined limits, the relatively exclusive right to use the resource, to derive income from it and to transfer it to other owners.

A substantial measure of exclusivity in property rights within clearly defined limits generally provides incentives for efficient resource use. Exclusivity helps to ensure that individuals face the consequences of their actions. For example, when a farmer has relatively exclusive rights to use and retain income from the use of land, he or she has incentives to use the property efficiently. If the land is grazed, all of the costs of grazing are borne by the owner of the land and are therefore taken into account in decisions on how to use the land. Where use is not exclusive, one person typically will not take into account the costs their use of the land imposes on others. The result is that the land will be over-grazed. Exclusivity provides incentives to invest in improving resources since the benefits of such investment are captured by the owner. It provides incentives for the owner to invest in information relevant to the best use of that resource and ensures that the person with the best knowledge of the resource makes decisions relating to its use.

A reduction in the right to retain income from the use of a resource, for example because of taxation, may reduce the incentives to use it efficently.

Transferability of well-defined property rights means that resources tend to be directed to their highest-valued uses and users. Anyone who places a higher valuation on a given resource than its current owner, due to either differences in taste or productivity, can bid in the market for the ownership or use of that resource.

The right to transfer property rights allows the right to contract. Individuals will utilise the resources they own in a way which maximises welfare. They may directly employ the resource themselves or enter into contractual arrangements with others to attain increased value. In contracting, the owner of the resource may forgo some or all of his or her rights to decide the use of the resource in exchange for income for a period of time. The owner may delegate the right to use the resource in exchange for remuneration or combine with others in

joint venture or other contractual arrangements.[120] The combining of resources by several owners in a project involves partial or outright transfer of property rights through contract. The contract will generally stipulate the distribution of income amongst the participants and the conditions of resource use.

Costs are associated with private property rights. When transaction costs are high, rights may not be traded and the initial right assignment will affect the efficiency of the outcome. Efficiency may be forgone if the right is not allocated to the person who values it most highly. Generally, changes in assignments of rights occur through time as the relative values of conflicting uses change.

Resources may be expended in rent-seeking. People may lobby the government for special rights such as import licences that enhance their existing rights by excluding rivals. Costs may be incurred in searching out contractual partners, in negotiating and in enforcing contracts for the exchange or use of resources.

The protection of property rights - for example by erecting fences around a farm or maintaining a police force - involves costs. Costs may be incurred in enforcing contracts for the exchange or use of resources. The costs of excluding others from using a resource may exceed the benefits of exclusivity. However, the existence of private property rights does not necessarily preclude the rights being made non-exclusive by the choice of the property owner.[121] For example, high country farmers may allow trampers access across their land because the costs of exclusion exceed any benefits. However, they may enforce exclusivity during the lambing season when the benefits from exclusion are higher.

Exclusivity in property rights may provide opportunities for opportunistic behaviour on the part of individuals that own property. For example, where a company wishes to construct a pipeline and needs to negotiate right of way with many land owners, it may be efficient for the government to reduce the exclusivity of the land owners' property rights. Once construction of the pipeline has commenced, it may be costly to divert its path. People knowing this may be able to hold-up the pipeline company and obtain a price for access to their land far in excess of the opportunity cost of the land. The result would be a misallocation of resources relative to a situation in which the government imposed right of way requirements.[122]

1.5 Less Exclusive Rights

Where rights are not clearly specified or where they do not ensure a significant measure of exclusivity, the result will be to reduce the incentives to use resources efficiently (if the costs of defining exclusivity or clearly specifying rights do not outweigh the benefits). There would be little incentive to invest in a factory if others were able to use it without obtaining the owner's agreement and providing compensation. Where ownership of a resource is not exclusive, there is a tendency for it to be used too much (again only if the costs of defining exclusivity do not outweigh the benefits). For example, where a fishing resource is publicly owned no one is excluded from using it. Individuals have the right to exclusive income from their catch but no individual has exclusive income from the fishery as a whole, and nobody has an incentive to conserve the fish stock. If some constrain their catch others may catch more fish. Over-fishing results. Long-term gains are sacrificed for short term benefit. The Government's move to establish transferable fishing quotas is an attempt to establish some degree of exclusivity in property rights to different species of fish, thereby improving the long term utilisation of the resource.

---

120 Cheung, (1970), p 50.

121 Cheung, (1986), p 41.

122 Posner, (1986), p 49.

Non-exclusivity of property rights may be efficient where the costs of defining and enforcing exclusivity are higher than the benefits obtained. For example, it may be too costly to fully define and enforce rights over the fishery resource. The costs of enforcing property rights mean that some theft is tolerated.

The efficiency gains achieved by the clear definition and enforcement of relatively exclusive property rights constitute one of the major justifications for government intervention. In general, efficiency is promoted through clearly specifying the rights and limits on use attaching to resources and enhancing the exclusivity (in use and income) and the transferability of resources. Exclusivity tends to increase the extent to which the individuals who control resources bear the costs and benefits of alternative resource use decisions. The government may have a comparative advantage in deciding what limits should be attached to resource use in situations where the use of a resource would impose costs on individuals but transaction costs would prevent the negotiation of compensation.

1.6 Property Rights and Antitrust Policy

Private arrangements which minimise transaction (and production) costs usually develop within this general framework of private property rights. Many of the arrangements adopted are not well understood (particularly by those who choose to ignore transaction costs) and outcomes may appear to be imperfect when compared with theoretical models.

In some circumstances, alternative institutional arrangements can be identified that would result in a more efficient outcome.

Antitrust laws can have the effect of preventing a firm embarking on arrangements that improve its profits but which result in the forgoing of transactions that would be beneficial. For example, antitrust laws may prohibit collusion or mergers that would improve the participants' profits but reduce the beneficial transactions that are undertaken.

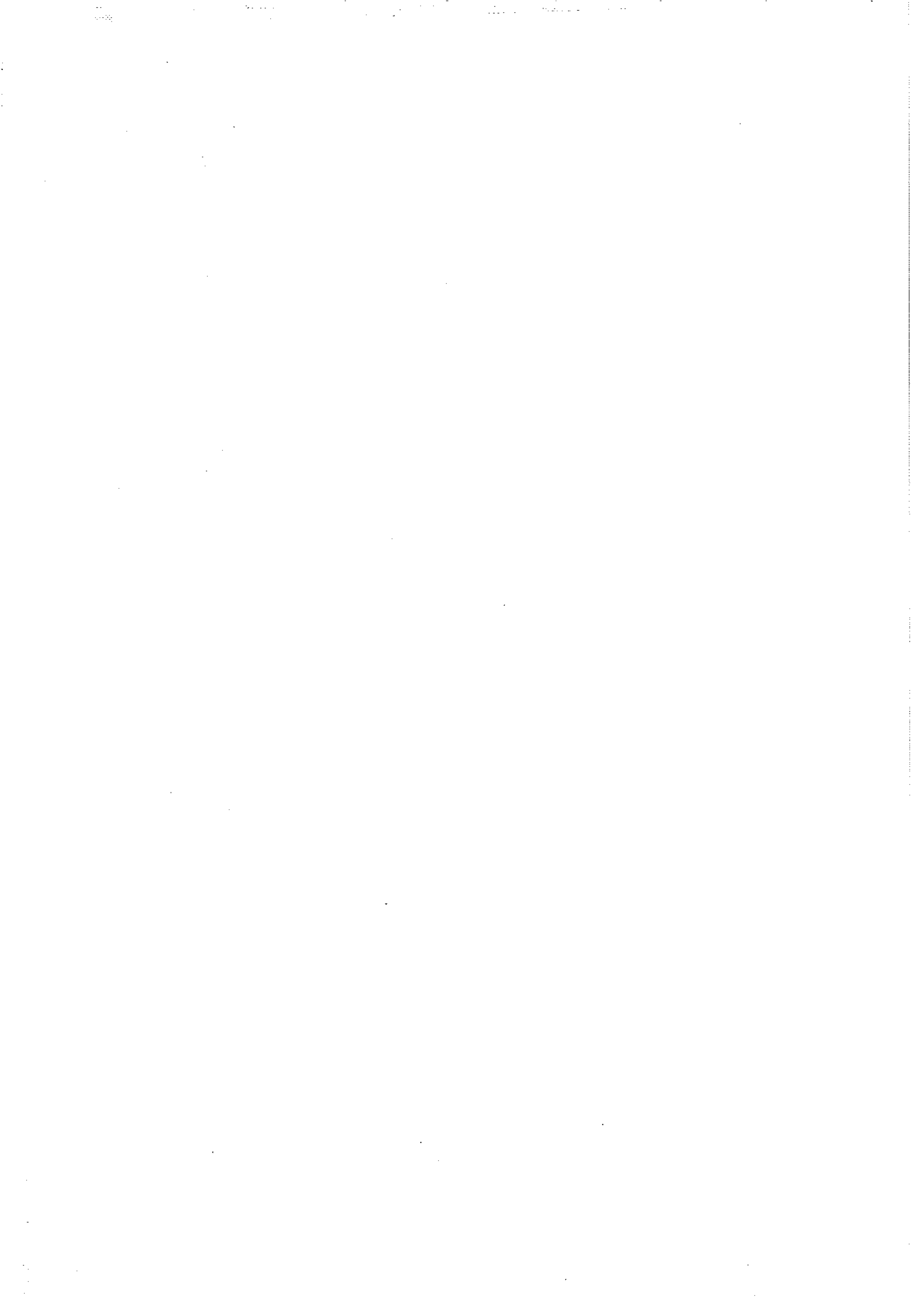
Antitrust laws act by modifying property rights. In general, they impose limits on the right to decide the use of assets and the right to transfer assets (including the right to contract for the exchange of property rights).

Antitrust laws will increase uncertainty about the rights attaching to resource ownership. They will therefore involve costs. An attenuation in the right to decide the use of resources will reduce the incentives to invest in improving assets and putting them to their highest valued use. Restrictions on the right to transfer assets will similarly reduce the ability of people to reallocate resources to their most highly valued use. Restrictions on the right to enter into complex contracts will have a particularly adverse impact on arrangements designed to minimise transaction costs. Similarly, restrictions on mergers and takeovers of firms will limit the effectiveness of the market for corporate control.

Specific intervention by the government, for example price controls, will involve additional costs. Such limits on property rights are difficult to enforce because of the information requirements faced by the government. The government will incur costs in obtaining the information necessary to enforce such constraints. Costs will be incurred when the limits are inappropriate. Incentives to invest may be altered in a welfare-reducing manner by such constraints.

Antitrust intervention will be successful only if it results in lowering overall transaction costs. If such an intervention increases transaction costs, overall productivity will be reduced and society will be worse off. There is little point in facilitating the transactions prevented by monopoly if, in the process, other more valuable transactions are forgone.

A discussion of the variety of private arrangements achieved within the general framework of property rights and an explanation for their development in terms of transaction costs is presented in Section 3 of Chapter One.



Section 2 The United States

2.1 Origins of Antitrust

Competition law or, more specifically, law which commands rather than regulates competition, is largely an invention of the United States. The Sherman Act of 1890 contains two main prohibitions:

Section 1 "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is hereby declared to be illegal..."

Section 2 "Every person who shall monopolise, or attempt to monopolise, or combine or conspire with any other person or persons to monopolise any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a misdemeanour..."

Read literally, these prohibitions have a broad scope, and reflected a typically American belief that unchecked concentrations of power, political or economic, are inherently pernicious. As Senator Sherman said, "if we will not endure a king as a political power, we should not endure a king over the production, transportation, and sale of any of the necessaries of life."[1]

Since every contract, by necessity, restrains its parties in some respect, Senator Sherman made it clear that the courts would be expected to distinguish between "lawful combinations in aid of production and unlawful combinations to prevent competition and in restraint of trade... It is the unlawful combination, tested by the rules of common law and human experience, that is aimed at by this Bill".[2] Somewhat remarkably, a rather cogent body of law grew out of this loose prescription. The law developed so that restraints clearly ancillary to a legitimate goal were allowed, but restraints having no other apparent purpose than the creation of power over price or the exclusion of competitors became unlawful.

Initially, the passage of the Act itself seemed sufficient to assure the public that economic power was to be held in check, and enforcement was not vigorous. Nonetheless, important precedents were established, and the right of the government to intervene in private economic arrangements became recognised by the business community. In **US v Addyston Pipe & Steel Company** (US Supreme Court, 1899), six manufacturers of cast iron pipe were charged with price fixing and customer allocation. Rejecting the argument that the prices fixed were "reasonable," the Court wrote "...we do not think that there is any question of reasonableness open to the courts in reference to such a contract. Its tendency was certainly to give defendants the power to charge unreasonable prices had they chosen to do so."[3]

Cases involving mergers and holding companies included, most notably, **US v Standard Oil Company of New Jersey, et al.** and **US v American Tobacco Company,** both decided in the Supreme Court in 1911. Both were found to be in violation of Section 2, and both resulted in a forced break-up of the firms. In each case, the court concentrated upon the intent to create a monopoly, as in **Standard Oil** where the Court found "...an intent and purpose to exclude others, which was frequently manifested by acts and dealings wholly inconsistent with the theory that they were made with the single conception of advancing the development of

---

1 Quoted in Neale and Goyder, (1980), p 16.

2 ibid, p 16.

3 The Supreme Court was quoting Appellate Judge (later President and Supreme Court Chief Justice) Taft in **US v Addyston Pipe & Steel Co. et al.**, 85 Fed. 271, 284 (1898).

business power by the usual methods, but which, on the contrary, necessarily involved the intent to drive others from the field and to exclude them from their right to trade, and thus accomplish the mastery which was the end in view."[4]

2.2 The Results of Early Decisions

Through these and other early decisions American antitrust law acquired several important characteristics. These include first, an emphasis on substance rather than form, where the effect of a conspiracy or combination was the measure of its lawfulness, rather than its particular legal form. Secondly, the so-called "rule of reason" approach was adopted, with apparent "restraints of trade" being evaluated in the context of their surrounding circumstances to distinguish possibly beneficial pro-competitive constraints from those whose likely effects are anti-competitive. Thirdly, an emphasis was placed on competition and freedom to trade, and its expected effects on consumer prices and variety of choice, as contrasted with other goals such as distribution of income or the protection of small traders. Fourthly, to the extent possible, there was a concern to establish a body which would allow predictable outcomes, so that it could serve as a guide to future remedies, particularly through equitable relief in civil proceedings (frequently with the Government as the plaintiff) such as court-ordered divestiture.

2.3 Antitrust Legislation in 1914

In 1914 Congress supplemented the Sherman Act with two new pieces of legislation. The Clayton Act declared illegal four specific types of restrictive practices. Briefly, they are:

(a) price discrimination (Section 2);
(b) exclusive dealing and tying contracts (Section 3);
(c) acquisition of competing companies (Section 7); and
(d) interlocking directorates (Section 8).

Each of these sections is qualified to the effect that the practice concerned is unlawful only when its "effect may be to substantially lessen competition or tend to create a monopoly".

In a separate Act, Congress created the Federal Trade Commission, charged with a dual responsibility of consumer protection (including false and misleading advertising, labelling of goods, and so on) and enforcement of the antitrust acts through the general declaration that "unfair methods of competition" were unlawful (Section 5). It was assumed that these words would include the provisions of the Clayton Act. The Federal Trade Commission has no criminal jurisdiction; it is an administrative agency with quasi-judicial powers, entitled to issue "cease and desist" orders when it finds violations of the law. These orders are subject to appellate court review, and with regard to the antitrust acts the legal standards are the same regardless of whether the action begins in the Justice Department, the Federal Trade Commission or through the action of a private plaintiff.

2.4 Merger Policy in the 1950s and 1960s

With a subsequent amendment in 1950 (to include asset as well as stock acquisitions), Section 7 of the Clayton Act became the basis for a broad attack upon mergers in the 1950s and 1960s. Interestingly, these attacks probably showed the first extensive incursion of academic economics into antitrust analysis. Oligopoly theory, the explanation of the interaction of the firms within an industry consisting of only a few large firms, flowered in the economic literature, and was reflected in enforcement policy and court decisions. **In US v Brown Shoe Company** (US Supreme Court, 1962) a case involving the merger of the two firms, each of which manufactured and retailed shoes, the Court considered a multitude of factors, such as an increase in the number of retail outlets controlled by shoe manufacturers, an increase in the

---

4 **US v Standard Oil Co. of New Jersey, et al.**, 221 US 1, 79 (1911).

fraction of shoes sold through these outlets which were self-supplied and a decrease in the number of manufacturers. The market shares involved were small; the combined market share in manufacturing was 4.5 percent and in retailing 8 percent, but the Court seemed to give greater weight to the overall impact of the merger on competition in the industry than on quantitative factors.

Although the theories upon which the analysis implicitly rested were later largely discredited, the attempt at an overall analysis of the industry was not unwelcome. However, this approach was largely ignored by the Supreme Court the following year in **US v Philadelphia National Bank** (1963), where the decision turned largely upon an analysis of market share alone. Indeed, the Justices pointed out in a footnote that "scholarly opinion" had suggested that a 20 or 25 percent market share would be sufficient to begin to draw an inference of substantial lessening of competition.

This largely numerical approach to merger analysis reached its apparent zenith in **US v Vons Grocery Company** (US Supreme Court, 1966), where the merger of two retail grocery chains in Los Angeles having a total market share of 8.9 percent were found to be in violation of Section 7.

In 1968 the Department of Justice issued its first "Merger Guidelines," intended to inform the business community of its enforcement policy. Its centrepiece was a set of specific numerical standards showing the market share which would trigger enforcement action. As an example, in an industry having a four-firm concentration ratio of 75 percent or more, two firms each having only 4 percent of the market could not merge; in an industry with a four-firm concentration ratio less than 75 percent, the corresponding threshold was only 5 percent.

This formal numerical approach to antitrust enforcement was welcomed by some observers. First, it had at least the trappings of being based upon some economic theory. Secondly, it appeared to be predictable, a hallmark of good law, and, finally, it was seen by some as a positive advance towards a more effective and beneficial antitrust policy.

The Courts apparently adopted the same general approach with regard to the other sections of the antitrust laws, attempting to formulate rules which would distinguish permissible from impermissible behavior in relative isolation from the particular circumstances of each case. Some of these rules such as the *per se* rules against price-fixing or bid-rigging preceded the developments on the merger issue and still stand as firm guidelines for commercial behavior and a basis for criminal action when necessary. However, in general, the static economic models which led to such rules have been shown to be a poor description of reality and a poor prescription for policy.

2.5 The Antitrust Revolution

There has been a revolution of sorts, or perhaps a counter-revolution, in both the United States antitrust enforcement agencies and the Courts, with a move away from the abstract models of the 1960s and towards more fundamental economic analysis. This revolution had several apparent sources. One contribution arose from the interaction among economists and legal scholars at the University of Chicago. Both students and faculty contributed to the economic analysis of legal questions, producing works including, notably, Richard Posner's *Economic Analysis of the Law* (1972), and Robert Bork's *The Antitrust Paradox: A Policy at War with Itself* (1978). The later work had been cited in five Supreme Court decisions and 35 Appellate decisions by 1985. Two scholarly journals from the University of Chicago, *The Journal of Law and Economics* (started in 1959) and *The Journal of Legal Studies* (started in 1972) have been joined by many others devoted to the economic analysis of the law.

A second apparent source of the antitrust revolution was a growing realisation that the United States was increasingly forced to compete in a world economy, and that inefficient policy would place American firms at a disadvantage relative to their foreign rivals. Looking at a list of the largest industrial companies in 1960, one finds 24 American firms

before the first foreign firm appears. In the same list for 1980, the first United States firm lies tenth on the list.[5] The final, and probably most important, source is the spread of economics from the hands of the economists to the Bar and the Judiciary. Posner, Bork and William Baxter (who, as Assistant Attorney General in charge of the Antitrust Division of the Department of Justice, was largely responsible for the 1982 revision of the Merger Guidelines) were all trained as attorneys, yet have led the introduction of modern industrial organisation economics into antitrust analysis. Serious economic analysis is now part of the legal tool kit of lawyers, judges and law clerks, and recent Supreme Court decisions, many containing pages of economic analysis and numerous references to both theoretical and empirical economic treatises, oblige judges in the lower courts to learn their economics and use it in their own decisions.

2.6 The New Antitrust Merger Law

The results of this revolution have been dramatic. In merger law they can be chronicled by looking at the successive revisions of the Merger Guidelines. As mentioned above, the first of the Guidelines was issued in 1968. The emphasis was upon structural measures of competition.[6] Horizontal mergers were to be measured against strict numerical standards which prohibited even relatively small firms from merging. Further, economies resulting from a proposed merger were not to be considered. Interestingly, the 1968 Merger Guidelines made no provision for counting the effects of foreign competition, reflecting perhaps an isolationist philosophy that the United States has only recently begun to abandon.

The 1982 Guidelines reflect a substantial rethinking of merger policy, undoubtedly influenced by academic developments in the field of industrial organisation.[7] There was a substantial

---

5 Baldridge, (1986), Appendix A.

6 This rigid emphasis on structural measures of competition reflected the influence of the "structure - conduct - performance" paradigm of industrial organisation pioneered by Joe S Bain. This view implies a strong link between the structural characteristics of a particular industry (i.e. number and concentration of producers) and its performance in terms of consumer welfare (see, for example, Joe S Bain, "Relationship of Profit Rate to Industry Concentration: American Manufacturing, 1936-1940," *Quarterly Journal of Economics*, 65, August 1951, pp 293-324). A review of this literature can be found in F M Scherer, *Industrial Market Structure and Economic Performance*, Second Edition, 1980, pp 267-297; in H Demsetz, "The Market Concentration Doctrine," *AEI - Hoover Policy Studies*, August 1973; and in H J Goldschmid, H M Mann, and J F Weston, eds., *Industrial Concentration: The New Learning*, Little, Brown and Company, 1974.

7 Since Bain's 1951 article, economists have devoted considerable effort to analysing the empirical relationship between market structure and industry performance. However, the early studies suffered from very serious methodological and data problems. Many of these studies found a positive correlation between market concentration and average profitability. As Demsetz has pointed out, the correlation may have nothing to do with the exercise of market power or collusive behaviour. Innovative firms that discover superior products and/or lower cost production processes are rewarded both with higher profits and higher market shares in competitive markets. Because the relative importance of this innovative behaviour differs across industries, the result of this process may be a cross-sectional correlation between industry concentration and profitability. Industries where leading firms have made substantial product or cost innovations will tend to exhibit higher concentration and profitability. Demsetz provides empirical support for this view by demonstrating that the profitability of non-leading firms is unrelated to industry concentration. This contrasts with the collusion hypothesis which predicts that higher concentration should raise the returns of all firms in the industry. He concluded: "[T]hese data fail to provide evidence that collusion in the absence of superior performance is easier or more successful in concentrated industries than in unconcentrated industries." (H Demsetz, "The Market Concentration Doctrine," *AEI - Hoover Policy Studies*, August 1973, p 21) Also, see Brozen, "Concentration and Profits: Does Concentration Matter?", *Antitrust Bulletin* 19 (Summer 1984), pp 381-399. Most recently, working with data collected by the Federal Trade Commission covering approximately 470 corporations for the years 1974-77, and disaggregated into individual lines of business, researchers have found the absence of any effect of market concentration on industry profitability. Research based upon these data yielded 63 papers by February 1986. For a brief review of

rethinking of merger policy, undoubtedly influenced by academic developments in the field of industrial organisation.[8] There was a substantial liberalisation of the numerical merger standards. In addition, it became clear that numerical standards represented necessary minimum thresholds that parties must have exceeded before any further economic analysis was done, rather than sufficient conditions for a case to brought.

Besides this change in numerical standards, the 1982 Guidelines recognised much broader substitution possibilities for both consumers and producers. This brought the focus away from mere market measures and instead towards a more realistic assessment of the question of whether the combined entity would have any real power over price and output. This included an explicit consideration of the role of entry in limiting the economic power of the combined entity as well as specific inclusion of the effects of foreign competition. The 1982 Guidelines also expressly provide for production, management or other efficiencies. Their mention, however, is relegated to a section at the very end (Section V) termed "Defences", and the efficiency defence is limited to "extraordinary" cases.

The most recent Merger Guidelines, issued in 1984, were accompanied by an official statement regarding the evolution of the Justice Department's merger policy. In that statement the Justice Department commented retrospectively on its own 1982 Merger Guidelines[9]:

> "The 1982 Guidelines did not simply clarify the Department's merger policy, however, they also represented an important advance in merger analysis. The 1982 Guidelines recognise that most mergers do not threaten competition and that many are in fact pro-competitive and benefit consumers. Moreover, the 1982 Guidelines reflected for the first time the important role that foreign competition plays in the Department's merger analysis. They thus provide a flexible analysis that proscribed only those mergers that - on the basis of sound economic and legal analysis - threaten competition". (p S-13)

They went on to comment on their latest revision. Several changes are of importance:

(a) on a new entry: Expected entry within a year in response to a "small but significant and non-transitory" increase in price should be considered as being already in the market;

(b) on the expansion of output of "fringe firms": "[T]he Department is less likely to challenge a merger if small or fringe firms are currently able to expand significantly their sales at incremental costs that are approximately equal to their incremental costs at current levels of output";

(c) on foreign competition: Foreign competition, including the ability to divert sales to the United States from other markets, is in the absence of legal import barriers to be counted as being fully equal in importance to domestic production;

(d) on efficiencies: The Department clarified its position by stating that it "never ignores efficiency claims" and "considers and gives appropriate weight to efficiency claims in all cases where they are established by clear and convincing evidence".

---

this work, see F M Scherer et al., "The Validity of Studies with Line of Business Data: Comment", *American Economic Review*, 77, March 1987, pp 205-217.

8 *Antitrust and Trade Regulation Report*, 54, (1988), p 477.

9 *Antitrust and Trade Regulation Report*, June 14, 1984.

A similar evolution (or revolution) can be seen in the approach taken by United States authorities to vertical or conglomerate mergers. The United States antitrust law does not explicitly identify vertical or conglomerate mergers; rather, it condemns all mergers that tend to diminish competition. The early cases posited a potential concern with vertical mergers to the extent that a supplier would be foreclosed from access to a purchaser of its product or vice versa. The early theory offered in support of conglomerate merger prohibition was that such mergers would "entrench" the market position of large firms. It was even argued that potential efficiencies flowing from synergy in a conglomerate should count against a merger because these would make the combined firm more of a permanent market presence.[10]

Since 1968 economics teaching has come to pervade both legal scholarship and court decisions, and the entrenchment and foreclosure theories have given way. It was realised that "entrenchment" was no different a basis for attacking a merger than absolute size; and that considering synergies as a negative factor perversely denied consumers benefits from mergers that posed no real threat of competitive harm. Foreclosure was also recognised as no basis for antitrust scrutiny, especially at the low levels set by the 1968 guidelines. Consistent with economic analysis, both vertical and conglomerate mergers were only of concern for their horizontal effect. Examples would be a merger between potential but not actual horizontal competitors, or a merger between firms in a vertical relationship that might make entry more difficult for a future competitor. This development was expressed in the 1982 revision of the Department of Justice Merger Guidelines. The expression of antitrust interest in mergers purely for their conglomerate or vertical potential has now atrophied in the United States. There has been virtually no government antitrust concerns expressed in relation to vertical or conglomerate aspects of mergers in the United States in the past decade. With the exception of one non-litigated consent decree in 1981, the last Justice Department vertical merger case was 10 years ago. Only 13 vertical merger cases have been brought by the Department of Justice since 1914, the date of enactment of the American anti-merger law. The conglomerate merger cases that have been brought in recent times have been brought solely as horizontal competition cases. A concern with conglomeration, or size *per se*, was not expressed in these cases.

2.7 Trade Practices

A similar, more economic approach to trade practices was adopted by the US Supreme Court in 1977 with the **Sylvania** case.[11] Sylvania's practice of granting geographic areas of sales responsibility to its retail television dealers was upheld by the Court. This decision overturned a *per se* rule against territorial and customer restrictions for dealers (under certain conditions) as decided by the Court a decade earlier in a case involving bicycles.[12] In **Sylvania**, the Court concluded that non-price vertical distribution practices including, among others, exclusive dealing, exclusive territories, and refusal to deal, are not *per se* illegal and should be decided under a rule of reason. Under a rule of reason approach, the business reasons for a practice are fully investigated and weighed against any possible anti-competitive harm.

The Court concluded that "vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products" (p.55). Some of the efficiencies noted by the Court included: "To induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. Service and repair are vital for many products, such as

---

10 **FTC v Procter and Gamble Co.**, 386 US 568 (1967).

11 **Continental TV v GTE Sylvania**, 433 US 36 (1977).

12 **US v Arnold Schwinn and Company** 388 US 365 (1967).

automobiles and major household appliances. The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his products" (p 55).

The Court adopted an analytical framework for examining vertical restraints in which the loss in intrabrand competition (competition between distributors of a single supplier's goods) is weighed against the gain in interbrand competition (competition among manufacturers of the same generic product, such as refrigerators). The Court recognised that some vertical restraints, such as exclusive territories, restrict intrabrand competition, but do so in order to stimulate interbrand competition. The gains from increased interbrand competition in most cases outweigh any losses from reduced intrabrand competition.

Sylvania is just an example of a lengthening list of cases where economic efficiency was the controlling element in the test of the lawfulness of a practice. Arrangements which would clearly have been found unlawful a few years ago are now being recognised as either economically harmless or positively beneficial. This includes tying (**Jefferson Parish v Hyde**, 104 S.Ct 1551 (1984)), the termination of discounting distributors (**Valley Liquor, Inc. v Renfield Importers, Ltd.**, 678 F 2d. 742 (1982) and **Monsanto Co v Spray-Rite Service Corp.**, 104 S.Ct. 1464 (1984)) and even apparent price fixing (**Broadcast Music. Inc. v Columbia Broadcasting System**, 441 US 1 (1979)).

Contrary to the opinions of some observers, this is not a move away from antitrust, but rather a recognition that the world is a complex place, where simple labels mean little and real analysis is often necessary to ensure efficient results. This requires some mental effort, but the reward is an antitrust law that ensures competition without introducing unnecessary and inefficient restrictions on business behavior.

2.8 Enforcement

The Department of Justice will ordinarily bring criminal actions in market-sharing or price-fixing cases involving Sherman Act violations. The consequences can be severe, as violation of the Act was elevated to a felony in 1974 and the Department's policy is to seek prison sentences. Neither the Clayton Act nor the Federal Trade Commission Act involve sanctions. Instead, the usual remedy is injunctive relief or a Federal Trade Commission "cease and desist" order. The Department of Justice must seek relief through the ordinary Federal Court system and has access to the usual devices of document discovery and pre-trial depositions (oral testimony under oath). The Federal Trade Commission has access to similar compulsory processes when approved by the five member Commission. Proceedings are taken before an Administrative Law Judge, who makes written findings. These findings are advisory to the Commission, whose decision and order can be appealed on matters of law to a Federal Appellate Court.

2.9 Pre-Merger Notification

In 1976 the Antitrust Improvement Act (commonly called the Hart-Scott-Rodino Act) required that advance notice of mergers be given to the government if they involved: (1) a transaction of over $15 million, or (2) one party had annual net sales or assets of $100 million and (3) the other party had annual net sales or assets of $10 million. The notice is given on a preprinted form, which requests information about the parties, the transaction and the businesses the parties are engaged in, categorised by census industrial classification codes. Generally the parties are required to provide only 30 days notice (15 days in the event of a cash tender offer) before closing the deal. This time is extended if the government requests additional information (a "second request") only by the time it takes the parties to provide the requested information. The Act does not give the enforcement agencies any new power to block the merger. Instead, it is intended only to provide time for the enforcement agencies to go to Court and seek an injunction against the merger.

Both the Justice Department and the Federal Trade Commission participate in the process, dividing the cases according to the areas of their respective expertise. When an application

reaches either agency, a team consisting of both economists and lawyers evaluates the application, seeks information from customers and competitors (using compulsory processes, if necessary) and makes recommendations to the Assistant Attorney General in charge of the Antitrust Division (in the case of the Justice Department) or the Commissioners (in the case of the Federal Trade Commission).

Parties to the transaction are invited to participate in the proceedings and may make written and oral submissions to both staff members and higher level officials. Of particular interest are any efficiency gains from the proposed merger, whether the benefits ultimately flow to the public or nor. Evidence of such gains not only demonstrates the public benefits which will flow from the merger, but also provides an alternative to any supposed anti-competitive motivation.

In the event that the proposed merger is judged by the agency to be anti-competitive, the agency must take the case to a Federal court and ask for an injunction blocking the merger. There is no presumption that the agency is correct, and the agency is not always successful. Frequently, the merger can be saved by selective divestment of certain lines of business or even individual manufacturing facilities. Both the Justice Department and the Federal Trade Commission are willing to discuss such remedies. If agreement is reached, it can be memorialised in a consent decree or a consent order which specifies the assets to be divested, the date the divestment must be completed and procedures for assuring that a viable independent competitor is created by the divestment. Such orders are made public before they are put into effect, allowing comment to be made to the Court in which the order is to be filed (in the case of Justice Department consent decrees) or the Commissioners (in the case of Federal Trade Commission consent orders).

This pre-merger notification procedure is a substantial improvement in the antitrust law. Although most proposed mergers gain quick approval (only about 4 percent even get to the stage of a second request), it allows the government to block anti-competitive mergers before they are consummated. Under the old system, where the government was not even aware of a merger until after it occurred and litigating the case typically took several years, it was often too late to successfully "unscramble the eggs", and although the government might win the case, the remedy was often unsatisfactory and ineffectual.

One drawback of the procedure is that the proceedings produce no record and have no precedental value. Thus, they do not serve as a guide to future behavior (and a great amount of time and money is typically invested in a merger before it reaches the filing stage) and provide no promise that similarly situated applicants will be treated similarly.

The division of enforcement powers between the Justice Department (which is part of the Executive Branch, under control of the President) and the Federal Trade Commission (which is a creature of, and reports to, Congress) is a result of historical factors unique to the United States political system. Although the system functions smoothly, such a division of powers is unnecessary in a parliamentary system.

2.10 Private Antitrust Actions

Private plaintiffs, who have been harmed by anti-competitive activity (or stand to be harmed) have standing under the Sherman and Clayton Acts. They may ask for injunctive relief or damages. If damages are awarded, both Acts dictate that plaintiffs will receive three times their actual damages. In addition, successful plaintiffs receive compensation for their legal costs (the usual case in the United States is that each party pays its own legal expenses regardless of the outcome of the trial), States Attorney General may sue on behalf of their citizens in *parens patrial*, and private attorneys may file a class action suit for a group of similarly situated plaintiffs. The number of private suits is large (1,100 in 1984)[13] and, in

---

13 Whiting, (1985).

some cases, the awards are staggering. Many observers feel that the widespread compliance with the antitrust laws is more the result of the fear of private action than of government enforcement. Others, however, note that many private antitrust actions merely gloss over ordinary business disputes such as contract claims, franchise termination disputes or business torts, added merely on the chance that the Court or jury will be persuaded and the damages thus tripled (in the United States, any action involving damages in excess of $20 must be heard by a jury at the request of either party).

2.11 Reporting of Business Practices

Although proposed mergers are reported to the government under the Hart-Scott-Rodino Act, the law does not require the reporting of any business practice which potentially offends the antitrust laws. Indeed, it is the usual presumption that it is the responsibility of individuals to know the law and avoid violating it.

Although both the Justice Department and the Federal Trade Commission have provisions to issue advice on proposed practices, they are limited in scope and infrequently used. The Department of Justice in some cases will issue a "Business Review Letter", stating whether it intends to bring criminal action against a proposed scheme. It reserves the right to bring a civil action later if it wishes to test the legality of the proposed practice. Similarly, the Federal Trade Commission may issue advisory opinions on novel questions of general interest. Provided the proposed practice was fully disclosed, the Commission will not bring an action unless the opinion is rescinded and then only for the period after the rescindment.

Although these provisions might seem similar to the authorisation procedures in place in New Zealand and elsewhere, they are not. They are optional and only infrequently used, involve no detailed investigation and result in no publicity available detailed opinions or record (Federal Trade Commission advisory opinions are published, but do not have the depth of a Commission Report). Most importantly, they are not law, and do not preclude a private party from bringing an action based upon the very scheme which the opinion describes. There is no provision for special exemptions by any administrative agency. Only Congress can grant exemptions, and these are usually limited to industries otherwise regulated. Legitimate state action, in the public interest and commanded and supervised by state governments, is generally beyond the reach of the Federal antitrust laws, but the exemption is interpreted narrowly.

Finally it is worth noting that the individual states also have systems of antitrust laws varying widely in scope, severity, and the intensity of enforcement. Through actions in state courts, plaintiffs may recover for antitrust harm which might not be recognised by Federal law.

2.12 Current Thinking on Antitrust in the United States

The description of the recent changes in antitrust thinking as a "revolution" is not inappropriate. It has all of the traditional trappings of a revolution as they ordinarily occur in any science. It started with a small group of "believers," initially armed more with theories and insight than with empirical evidence. As more economists and legal scholars became converts, it began emerging into something approaching a new orthodoxy. This emergence is now virtually complete. In a speech given at the University College of London on June 13, 1988, Dr Betty Bock, Senior Law Fellow of Antitrust Research at the Conference Board in New York City, could remark that within the courts it is:

> "...now more generally recognised than before that the issue being posed in antitrust is not whether a given business practice (or structure) fits into past precedent concerning categories of monopolisation or of restraint of trade...but whether a practice is reasonable under the competitive circumstances, because if it is, it is likely to increase

competitive rivalry, lead to additional output, intensify innovation, and in the end result in lower prices and/or more effective products for consumers."[14]

Certain beliefs arising out of this new orthodoxy are now so widely held that they become the starting point even for those who disagree. With regard to vertical restraints, Thomas J Campbell, as a moderator at a recent discussion at the Annual Spring Meeting of the Section of Antitrust Law, American Bar Association, encountered no objections when he introduced the discussion with the observation: "I take it that all reputable economists agree now that there is nothing to vertical restraints in and of themselves; they are of concern only if there is a horizontal difficulty."[15]

However, as with any scientific revolution, the new orthodoxy does not end discussion, it only changes the starting point. Dr Campbell was starting off a discussion of the recent research of Steven C Salop, who is among the forefront of economists who are working on models which explain how firms may exclude competitors not through price predation but by preclusive buying and increasing rivals' costs.[16]

All in all, the current situation seems healthy. Although the revolution created economic presumptions about the efficiency of competition and has led the courts to look more carefully at the efficiency justifications or business rationale for a merger or trade practice, it has neither cut off economic discussion nor resulted in an abandonment of active antitrust enforcement by either the government or private plaintiffs.

---

14 *Antitrust and Trade Regulation Report*, 55, (1988) p 109.

15 See Campbell, (1987), p 92.

16 See Krattenmaker and Salop, (1986).

Section 3 Canada

3.1 Introduction

Canadian antitrust law, or competition law as it is known in Canada, antedates by one year the introduction of the Sherman Act in the United States. The original Canadian legislation was passed into law in 1889.[17] The origins of more modern legislation, in the form of the Combines Investigation Act, became law in 1910. While there were changes over the years to amend and modify this legislation, the basic tenets and features of the law remained in place until 1986 when the current Competition Act was passed.[18]

While there may be relatively few lessons to be learned from examining in detail the track record of decisions under the old Canadian law, there are some lessons to be learned from examining the changes introduced in the new Competition Act. Against these changes in law is the backdrop of reductions over the last fifteen years in the Canadian tariff barriers affording protection to Canadian domestic industry, especially secondary manufacturing. Most tariff barriers between the United States and Canada will be removed if the Canada-United States free trade agreement approved by the Canadian House of Commons (but not yet by the Canadian Senate) and the American Congress comes into effect.[19] For competition policy, there is the issue of whether the enhanced competition that accompanies tariff reductions will constitute a more significant pro-competitive impact on the Canadian market than any legislated competition policy. The issue is somewhat deeper than this, however. Countries with free trade will also compete for wealth, leading to jurisdictional competition, in particular with respect to competition law. Relatively inefficient laws will penalise firms located in the relevant jurisdiction to the detriment of the wealth accumulated in that region. The observation that the new Canadian Competition Act has moved Canada closer to the laws of the United States is consistent with this hypothesis.

3.2 New and Old Law

The old law was criminal in nature. This meant that the conventional standards applicable to criminal law were maintained to regulate commercial transactions; what were arguably civil issues were judged by criminal standards. Trials followed criminal procedures including the requirement of criminal burdens of proof for the Crown (guilty beyond a reasonable doubt). With large fines and jail sentences for corporate executives possible under the law, the courts laboured under a concern for interpretation of the meaning of the words in the Act. For example, on issues of conspiracy the law said that the prevention of competition must be undue or any price enhancement must be unreasonable. The courts struggled to know what was undue or unreasonable. If we leave aside issues of the proper definition of the market, firms that were held to have a 100 percent market share were nevertheless deemed by the courts not to contravene the Act unless the Crown proved detriment.

---

17 The original act was called An Act for the Prevention and Suppression of Combinations Formed in Restraint of Trade. For commercial actions to be challenged under this Act, they were to limit competition unduly, enhance prices unreasonably or constitute unlawful conspiracies. The Act was regarded as ineffective.

18 For a deeper history of the evolution of Canadian competition law, see Chapter 3 of Dunlop, McQueen and Trebilcock (1987).

19 Selected Canadian industries are exempt from the free trade agreement. For example, the Canadian domestic beer industry was exempted. Provincial regulations permit beer sales in some provinces only if there is corresponding beer production in the province. The argument is that because of these regulations the Canadian beer industry has been left with inefficiently small production units incapable of competing with the larger, more efficient producers in the United States. Consequently, the Canadian beer producers argued that they required additional protection and exemption from the agreement.

From the point of view of enforcement, many argued that the law had little effect. The Crown had few successful cases over a 70 or 80 year history. Some felt that even though the ceiling for fines was large ($10 million) and jail sentences were a possibility, the low probability of a conviction meant that the law was ineffective. Others, favouring a relatively non-interventionist antitrust policy, regarded the Canadian law under the old Act as operationally benign and therefore not to be faulted. With the frustration of continuing failure, the government sought changes in the law. Whether this frustration alone is sufficient to account for the change in the Canadian law is another issue.

The new Competition Act came into force in June 1986, with some sections sequentially phased in. The new Act maintained some sections of the old Act, in particular sections on conspiracy (S.32), bid-rigging (S.32.2), price discrimination (S.34), and price (S.38) and non-price (S.47 and S.49) vertical constraints. The principal changes involved mergers and monopolisation.

The new legislation decriminalised those parts of the old Act dealing with mergers, introduced pre-merger notification (when a firm of a specified size purchased another firm of a specified size in the same industry) and required that the merging parties demonstrate that the merger would not harm competition (similar to the "Hart-Scott-Rodino" provisions in United States merger law). The federal government agency charged with administering the Act is called the Bureau of Competition Policy, and the chief administrative officer is labelled the Director of Investigation and Research. In practice, this new law has meant that firms of sufficient size seeking to merge file a brief with the Director which typically includes an analysis of the competitive impact of the proposed merger. The Director and the staff of the Bureau, after conducting an analysis, either approve the merger, fail to oppose the merger or oppose the merger. Failure to oppose the merger means that the Director has a three-year period after the merger is complete within which to file opposition to the merger. Contested mergers that are completed can be challenged by the Director before a Competition Tribunal (the Tribunal). A panel is drawn from the members of the Tribunal to hear particular cases. The Tribunal has both lay and judicial members where the judicial members are appointed from judges of the federal courts. The Tribunal can dissolve or approve the merger. The Tribunal's decision can be appealed to the federal courts. To date, mergers contested before the Tribunal on which there are decisions offer no guidance to firms on the Tribunal's interpretation of the merger provisions of the new Act.

As well, the new Act replaced the sections on monopolisation under the old Act with a section on "abuse of dominant position" (S.30). No charges have been brought under this section of the Act. Section 30 of the Act is particularly problematical in that it contains a list of nine separate commercial practices which may lead to an abuse of dominant position, without guidance on when the law would find these practices pro-competitive or anti-competitive. The list includes vertical practices such as exclusive dealing[20] , witholding essential facilities from the market and squeezing by a vertically integrated supplier of an non-integrated supplier. Also included are obscure marketing practices such as the use of fighting brands to eliminate competition, product design issues such as non-compatibility of products to eliminate entry, and predation. In other words, this list is a "catch-all" of excluded commercial acts which the law alleges could be sinful.

3.3 Some Comparisons with United States Antitrust Law

In large part Canadian antitrust law, and in particular the merger provisions, have moved considerably closer to the American law.

20 Exclusive dealing is dealt with both here and in S.49.

3.3.1 *Merger Law*

While the laws and procedures on merger analysis are similar in the United States and Canada, there are historical and institutional differences between the two countries. In moving from the United States to Canada, differences in market size and the long historical tradition of tariff protection in Canada make the application of the law quite different in the two countries.

Merger law provides a useful example. The current status of American merger law was outlined in Section 2. In particular, the United States Department of Justice (DOJ) has issued guidelines for both horizontal and vertical competitive issues. No such guidelines have been issued by the Canadian Bureau of Competition Policy. The DOJ has specified various threshold levels that are critical to their approach to specific mergers. To assess mergers, the DOJ uses an index that squares the percentage share of all participants in the market and then sums these for particular industries. Provided that there is some agreement about the definition of the industry[21], the DOJ has specified that if the post-merger index is below 1000, the market is considered unconcentrated. If the post-merger index is between 1000 and 1800, the government is unlikely to challenge the merger if the increase in the index is below 100 points but likely to challenge if the increase is more than that. Similar numbers for post-merger indices over 1800 are a 50 point increase with the addition that, in this case, the government will challenge except in extraordinary cases if the increase exceeds 100.

Canadian markets have developed under a tradition of "thinness" from the nature of settlement in the country - separated population centres with long distances between them - and a policy tradition of significant tariff barriers erected by the government to protect local industry, especially plants located to minimise the cost of the delivered product to the Canadian retail market. The government afforded inefficient local producers protection from foreign competition by erecting tariff barriers.[22] Under these barriers, there is a long tradition of small numbers of Canadian firms pricing up to the foreign product price including the tariff.[23] Canadian concentration ratios are therefore significantly higher than those in the United States. Absent the movement to free trade, the application to Canada of American standards for government opposition to mergers as set out in the DOJ guidelines would mean that most historical Canadian mergers of any size would have been challenged. With the removal of tariff protection and the movement towards a Canadian-United States pattern of production, this need not be the case. The mechanical application of American rules instead of the application of the principles would almost certainly yield inefficient results with respect to resource allocation in Canada. In the absence of Canadian guidelines, and with the importation of American guidelines seeming inappropriate, merger law is conducted on a case by case basis. While successful mergers are known, unsuccessful applications are generally not. It is difficult, therefore, to discover an implicit merger theory in the application by the Bureau of the Canadian merger law.

---

21 Definitions have proved to be contentious in Canadian cases. There is an obvious incentive for the applicants to wish to define the market broadly and for those opposed to the merger to maintain extremely narrow definitions of the product market.

22 This tradition of favouring domestic producers continues under the new Act as the Tribunal is instructed to consider in its evaluation of a merger, and in particular of the technical efficiency of the merged firms, whether the merger results in the substitution of domestic for foreign products.

23 This history and status of competition in manufacturing in Canada under the regime of significant tariff protection is developed in detail in Eastman and Stykolt (1967). The historical explanation of the structure of manufacturing in Canada has been labelled the "Eastman-Stykolt" hypothesis.

3.3.2 *Vertical Issues*

The law regarding vertical issues such as resale price maintenance, exclusive dealing, refusals to supply, tied sale and similar restrictions is unchanged under the new Act. A comparison with the development of jurisprudence in the United States on these matters is nevertheless helpful.

For the most part, Canadian practice on non-price restraint issues has been "state-of-the-art". However, this is largely a result of benign neglect on the part of the antitrust authorities, rather than of a state of analysis ahead of its time. Recent years have witnessed two vertical cases brought before the Restrictive Trade Practices Commission (RTPC).[24] In 1980, the RTPC decided in favour of the defence in an exclusive dealing case involving the distribution of snowmobiles in rural Quebec (the *Bombardier* case). In 1981, the RTPC decided in favour of the Crown in a tied sale case involving the required tied purchase of data on radio and television audience ratings (the *Bureau of Broadcast Measurement* case).

In contrast to the United States, territorial restrictions, customer restrictions, tied sales and exclusive dealing have rarely been issues in cases involving franchise and dealer contracts, contracts which frequently invoke restrictions on franchises and retail dealers. This means that in contrast to the United States which required a *Sylvania* decision in 1977 to undo the damage of the *Schwinn* decision a decade earlier, Canada, following an essentially non-interventionist policy, required no such corrective action.

The Canadian policy on resale price maintenance (S.38), however, has been more restrictive than that of the United States. Resale price maintenance (RPM) is *per se* illegal in Canada; there is no defence. There is nothing in Canada comparable to the Colgate doctrine in the United States. RPM cases have been the "bread and butter" of the Bureau of Competition Policy over a number of years.[25] The section of the Act dealing with RPM also deals with refusal to supply, a charge that frequently accompanies RPM allegations. For refusal to supply charges alone, however, there are some defences for the accused such as the retailer not providing the level of services that purchasers might expect, or retailers "loss-leadering" the product and thus damaging the image of the good. Again there is a paucity of cases under refusal to deal regulations.

3.3.3 *Other Issues*

Predation is also an infrequent charge, although it is dealt with under the Act as an abuse of dominant position (S.50). One recent case involved a branded drug firm (Hoffman-LaRoche) giving away one of its products to hospitals in response to the emergence of a generic substitute.[26]

Conspiracy and bid-rigging cases have garnered some success for the government. These cases typically involve charges of conventional cartel behaviour. Recent cases involve the charge of conspiracies in Alberta to fix hog prices, in Ottawa to fix hotel prices to federal government employees, and in Saskatchewan and Nova Scotia to fix prices in bids to governments to supply their demand for printed forms.

---

24 The RTPC was the precursor of the Competition Tribunal. The scope of decision making for the Tribunal includes that of the RTPC, plus the additional burden of contested merger review as a result of changes in the new Act.

25 For example, over the period 1954 to 1983 in Canada there were 71 RPM cases, all involving guilty verdicts.

26 While Canada's drug patent laws have recently changed, they had previously limited severely the patent life of branded drugs so that generic substitutes appeared soon after the introduction of a branded product.

3.4 Conclusions

The Canadian merger law has moved considerably towards practice in the United States by decriminalising mergers and requiring an examination by a federal government agency of proposed mergers prior to the acquisition.

On non-price trade restrictions, Canada has always been much closer to the current American practice. On price issues such as resale price maintenance, Canada has been more rigid. For resale price maintenance the fines are smaller in Canada, but growing.

Bid-rigging and price conspiracies have always been pursued with success for the Crown but there are limited numbers of cases and there are no triple damages in Canada. The Bureau is currently searching for larger and more significant cases on this front.[27]

As Canada and the United States move towards a free trade relationship, the impact of enhanced competition from the United States should have a positive and significant impact of the efficiency of resource allocation in Canada. Anticipation of this change appears to have already precipitated mergers and divestitures in Canada, as Canadian firms seek to align their assets to meet enhanced competition. There will also be jurisdictional competition between the two regulations for governing commercial transactions. This competition should also prove to be wealth-enhancing.

---

27 Information on the current status of competition law and cases in Canada may be found in the *Canadian Competition Policy Record* (Fraser & Beatty Legal Publications Inc.).

Section 4 The United Kingdom

4.1 Origins and Development

The United Kingdom had no antitrust legislation until the passage of the Monopolies and Restrictive Practices (Inquiry and Control) Act in 1948. The motivations for the Act were largely macroeconomic, reflecting a concern to promote employment, international competitiveness and price stability. The Act established a number of precedents for future policy. It relied on inquiry by a specially established Monopolies Commission, with the responsibility for decisions resting with the Government. Competition was seen primarily as a means to the greater end of furthering the public interest, "public interest" being broadly defined in terms of the employment, competitiveness and price stability objectives. It required a case-by-case approach, setting out no *per se* prohibitions.

The investigations of the Monopolies Commission centred on the activities of cartels. Their conclusion that such activities were almost always contrary to the public interest (as defined) led to new legislation in the form of the Restrictive Trade Practices Act 1956. This Act created a Restrictive Trade Practices Court and a Registrar of Restrictive Trading Arrangements. The presumption was that all restrictive trading or cartel agreements were contrary to the public interest, but that registered agreements could be allowed by the Court in special cases. The passage of the Act marked the beginning of a dual system of administrative and judicial antitrust procedures. Similar provisions and procedures were introduced for resale price maintenance in 1964.

In 1965 the 1948 Act was replaced by the Monopolies and Mergers Act, which extended its coverage to mergers and takeover bids. The procedure remained administrative, with the government having discretionary power to initiate an inquiry, and discretion to act on the findings of the Monopolies and Mergers Commission. 1974 saw the introduction of the Fair Trading Act, which established a Fair Trading Office with a role in taking cartel agreements to court, in taking monopoly or anti-competitive problems to the Monopolies and Mergers Commission and in advising Ministers as to which mergers should be considered by the Commission. The Act set out more precisely matters to be taken into account in determining whether practices were in the public interest, as a basis for decisions on both mergers and restrictive practices.

In 1976 there was a new Restrictive Practices Act, extending earlier legislation to apply to goods as well as to services, and a Resale Prices Act. In 1977 an official working party was established to review the operation of competition policy, and a new piece of legislation, the Competition Act, was passed in 1980. This Act extended the 1974 legislation to cover the practices of individual firms, and particular practices irrespective of their origins, which had the effect of "restricting, distorting or preventing competition" in the supply or acquisition of goods or services, as well as mergers, takeovers and cartels with this effect. Registerable restrictive agreements, covered by the 1976 legislation, remained the territory of the Restrictive Practices Court. The Monopolies and Mergers Commission was expected to concentrate on such activities as price discrimination, predatory pricing, tie-in sales, full-line forcing, rental only contracts, exclusive supply, selective distribution and exclusive purchase.

4.2 Mergers and Takeovers

Particularly in the case of mergers and takeovers, the emphasis in the United Kingdom as in New Zealand has been on an administrative, case-by-case (or "rule of reason") approach to the implementation of antitrust. As in the United States, the emphasis has on the whole been on the "substance" of practices (their overall competitive effect) rather than on their form.

In contrast to the United States, neither the Office of Fair Trading nor the Monopolies and Mergers Commission have set out guidelines for the permission or rejection of merger and

takeover proposals. This has led to complaints about the unpredictability of findings. There is discretion with respect to which mergers will be referred and to whether to adopt the recommendations of the Monopolies and Mergers Commission.[28] While any merger or takeover above a certain size[29] may be referred to the Monopolies and Mergers Commission, no more than three or four percent of qualifying mergers are actually referred. As the Office of Fair Trading does not make its preliminary analyses public, it is difficult to assess what the referral policy has been.

Little guidance is given to the Monopolies and Mergers Commission by its legislation; rather it is stressed that the Commission must take into account "all matters which appear to them in the particular circumstances to be relevant".[30] It is, however, instructed to have regard to the desirability of a number of factors, only some of which are directly related to the efficiency with which production is organised, including "effective" competition within the United Kingdom, the promotion of the interests of consumers, the use of competition to promote technological development, facilitating new entry into existing markets, the promotion and maintenance of a "balanced" distribution of industry and employment, and the promotion of competitive markets outside the United Kingdom to the advantage of British producers. In practice, takeovers by foreign companies have in some cases[31] been rejected on the basis of their adverse effect on the balance of payments and in others on the basis of their expected effect on the economy of a relatively depressed region.[32] In other cases, the Monopolies and Mergers Commission has recommended against takeovers on the basis of their adverse effect on management efficiency and morale in the target company.[33] It may be argued that the question posed of the Commission, of whether a merger or takeover operates *against* the public interest, makes for a relatively permissive policy. This permissiveness is probably enhanced by the breadth of the public interest test.

The approach of the Monopolies and Mergers Commission has changed over time. In the 1960s, under the developing influence of oligopoly theory, the emphasis was on defining the relevant market (typically qualitatively) and market shares. Such definitions tended to be narrow by economic standards, and there was little consideration of the nature and extent of entry barriers. There was usually some analysis of the cost savings that might arise from a merger, but there was little systematic analysis of the trade-offs between the effects of increased market concentration and cost savings. There was typically hostility to any merger or takeover that would create the largest firm in a market.

In the early to mid-1970s, the number of reports was increasing[34], but with no increase in the consistency of findings. It was at this stage that there was most emphasis on arguments about the detrimental effect of takeovers on managerial efficiency. In some reports, it was argued that the number of independent competitors was more important than their relative strength

---

28 At least up until 1985, the findings of the Monopolies and Mergers Commission had been followed by the Secretary of Trade and Industry with only one exception.

29 In 1985, the floor for consideration was a valuation of 30 million pounds, or the creation or strengthening of a market share of at least 25 percent.

30 The Fair Trading Act 1973, Section 84(1).

31 Such as a prospective takeover of Sothebys by a United States company.

32 As in the case of the proposed takeover by a Hong Kong bank of the Royal Bank of Scotland.

33 As in the case of Beechams' bid for Glaxo.

34 The Monopolies and Mergers Commission made only 6 reports between 1958 and 1965, as against 22 between 1966 and 1972.

as approximated by market shares, with an emphasis being placed in the cumulative effects of mergers on concentration than on the effects of a particular merger.

Since the late 1970s there has been an increasing emphasis again on market share analysis, 90 with mergers or takeovers being opposed where they would create or increase the largest market share in any reasonably concentrated market. Consideration of entry conditions continues to be rare[35], and the trade-off between the "anti-competitive" effects of increased concentration and cost savings through exploitation of economies of scale or scope continues to be largely ignored.[36] In the twenty years to the end of 1984, the Monopolies and Mergers Commission completed 54 reports on 61 distinct mergers, 29 of which were found to be against the public interest.

4.3 Restrictive Trade Practices

The effect of the Restrictive Trade Practices legislation is to make all restrictive agreements registerable with the Director General of Fair Trading, who must take them to the Restrictive Practices Court. Agreements required to be registered include restrictions on pricing, conditions of supply and distribution. These need not be set out in a formal contract. The Court must decide whether the agreement is justified for other reasons, the most general of which is that the practice will result in specific and substantial benefits to the public[37]. In allowing a practice, the Court is required to be satisfied that "the restriction is not unreasonable having regard to the balance between these circumstances and any other detriment to the public or to persons not party to the agreement...resulting or likely to result from the operation of the restrictors".[38] Between 1956 and 1985, 4420 agreements were registered, of which only 11 were eventually approved.

In the case of resale price maintenance, for which the British legislation comes closest to a *per se* prohibition, the practice can be permitted where without it product quality or variety would fall, the number of outlets would be substantially reduced, prices would rise substantially, public safety would be endangered, or after-sales servicing would be substantially reduced to the detriment of consumers. A similar proviso for the acceptance of one or more of these justifications applies as in the case of restrictive practices. Exemptions have so far been made only for books and pharmaceuticals.

A Green Paper released in March 1988 outlines significant changes to restrictive practices legislation. These would include replacing registration with a general prohibition, making unlawful any agreement (formal or informal) between two or more companies that had the effect of restricting or distorting competition. This would lead to a shift in emphasis from adherence to the word of the law to adherence to the spirit of the law, more compatible with EEC legislation. The general prohibition is, however, backed by an indication of particular interest in price-fixing cartels, collusive tendering, advertising restrictions and exclusive dealing. The law would be explicitly extended to professional groups such as lawyers, estate

---

35 The Nabisco/Huntley and Palmer and Trafalgar House/P&O cases, in which mergers were allowed on the grounds of low entry barriers that would have been rejected on market concentration grounds, are exceptions.

36 Fairburn, (1985).

37 A restrictive practice may also be justified as a means of protecting the public against injury, preserving or promoting employment or promoting export earnings.

38 Restrictive Trade Practices Act 1976, Section 10.

agents and accountants, who had been exempted under earlier legislation[39], although exemptions would continue to be allowed.

The public interest test is removed, on the basis that the existing test has enabled antitrust authorities to be diverted from the maintenance or promotion of competition, which is regarded as its appropriate goal. While this does not preclude consideration of the efficiencies that might arise from a practice deemed restrictive, the low emphasis in the past on the trade-off between pro- and anti-competitive effects of practices, and more generally the emphasis on competition - rather than economic efficiency - as the concern of antitrust authorities, raises concerns that the proposed legislation would prove unduly restrictive in practice.

Increased powers for the Office of Fair Trading are also proposed, including the right to enter and search premises (a right already held by European Commission competition officials), and to impose fines of up to 10 percent of the combined turnover of the companies involved. The Restrictive Practices Court would be retained as a forum for appeal against Office of Fair Trading decisions, with a right to impose higher fines. In general, however, there is a move away from judicial to bureaucratic administration, bringing the handling of restrictive practices more in line with the treatment of monopolies and mergers. Similar principles (in particular the move away from a public interest test) have not, however, been considered as yet in the treatment of mergers or of "anti-competitive" practices by individual companies.

4.4 Current Antitrust Issues

Two issues may be argued to be of particular importance to antitrust policy in the United Kingdom in the 1980s. The first is the privatisation of nationalised industries, and in particular industries thought to have an important natural monopoly component. The second is the approach of 1992, bringing greater emphasis on the part of the British economy as a subset of the broader European Community economy. There are clear parallels here with the New Zealand experience, both with regard to the handling of SOE deregulation and privatisation, and with regard to discussions of the relevance of CER to domestic antitrust policy.

Privatisation in the United Kingdom has not as a matter of course been accompanied by the removal of statutory monopoly powers. Thus in the case of British Gas, for example, new entry to the domestic market was effectively blocked in the legislation sanctioning privatisation, and in the case of British Telecoms the competition "created" in the form of Mercury was placed at a regulatory disadvantage. Rather than relying on existing monopolies and mergers and trade practices legislation to control the activities of privatised organisations, their privatisation has been accompanied by specific regulations and, in the two cases mentioned, by the creation of separate regulatory offices - Ofgas and Oftel. Regulatory powers are thus divided between the Secretary of State, these regulatory offices and the Monopolies and Mergers Commission.

Regulation of privatised industries is extensive. In the case of British Telecom, the underlying legislation requires that it act as a common carrier on its public network (at least for licensed competitors), prohibits "undue" preference or discrimination, limits the right to cross-subsidise, requires the creation of a separate subsidiary for equipment manufacturing, explicitly prohibits tie-ins, aggregated rebates and the "anti-competitive" use of intellectual property rights, and provides for the imposition of price controls on some services. The extent of regulation may at least in part be attributed to the failure to deregulate before privatising, a point emphasised by Vickers and Yarrow (1988).

---

39 Under the 1976 legislation, there were 47 separate exemptions, not only for professional practices, but also for practices involved with such diverse enterprises as the marketing of eggs and the construction of the Channel Tunnel.

European Community legislation, based on Articles 85 and 86 of the Treaty of Rome, is notable in that it contains no straightforward provision (outside the Coal and Steel Community) for dealing with mergers. Rather, it concentrates on restrictive trade practices (Article 85) and monopoly practices (Article 86). As under the British legislation (at least until the 1988 proposals are adopted), restrictive practices must be notified, and apparently have little chance of survival. The monopoly practices part of the legislation differs from that in the United Kingdom in that a "dominant position" is not defined in terms of market share, but rather in terms of the ability to prevent "effective" competition. Much of the debate in cases brought under the European Community legislation has centred on definitions of dominance and the abuse of dominance. Fairburn et al.[40] have argued that:

> "the Court has generally sought to identify abuse and, having done so, has generally found it possible to define a market such that the abuse is an abuse of a dominant position within the market."

For example, the definition of one of Michelin's markets as the market for heavy tyres in the Netherlands, a market in which it had a 65 percent share, enabled its payment of annual bonuses to dealers who performed well against sales targets to be defined as an abuse of a dominant position.

There is greater emphasis on judicial procedures than within the United Kingdom, in that the European Court of Justice has independent power to review the decisions of the European Commission on the permissibility of practices. Unlike the British legislation, where the role of private parties is effectively limited to lobbying and the provision of evidence to the Monopolies and Mergers Commission, the European Community legislation provides for private actions to be brought in the courts of member states. However, the Commission and Court have jurisdiction only over practices that affect trade between member countries.

The extent to which the European Community jurisdiction will change with further moves towards a common market by 1992 is unclear. It is notable that the committee preparing the 1988 Green Paper on restrictive trade practices considered that separate British legislation remained necessary both because many domestic agreements were felt to fall outside the scope of European law, and because the European system was already regarded as overloaded.

4.5 Summary

Antitrust in the United Kingdom continues to focus on competition, typically in terms of the concentration of relatively narrowly defined markets, even if competition is recognised only as a means to a greater social end. There is an implicit presumption that mergers are on the whole beneficial, and few mergers that fall within the purview of the Monopolies and Mergers Commission are actually reviewed. However, those which are reviewed would seem to have a low prospect of success relative to jurisdictions such as the United States, for a number of reasons. First, while the relevance of assessing entry barriers is recognised, they seem to be given little weight relative to concentration measures. Secondly, there is apparently little consistent effort to assess the trade-off between the cost-savings that might be achieved by a merger and the possible "anti-competitive" effects of increased market concentration. Thirdly, the broad public benefit test appears to have been used in some cases to reject mergers which might have been accepted on efficiency grounds. This raises the danger of politically motivated referrals. On the other hand, the rejection of a public benefit test in the 1988 Green Paper on restrictive trade practices must be of concern so long as the legislation remains focused on competition, with little attention to efficiency trade-offs. In general, there appears to have been far less willingness in the European Community and the United Kingdom to adopt insights from economic analysis in either the construction or the application of antitrust policy.

---

40 Quoted in Hay and Vickers, (1987), p 37.

Concern with the discretionary nature of the legislation[41] has focused in particular on the breadth of the public interest test and associated unpredictability of findings. The costs in terms of permission of harmful activities and prevention or dissuasion of potentially beneficial ones are clearly recognised. The response appears to have been rejection of the public benefit test (as in Hay and Vickers (1987) and the 1988 Green Paper) rather than its reformulation in efficiency terms. Indeed, George (1985), commenting on the problems of the public benefit test writes:

> "It has...been suggested that the [Monopolies and Mergers Commission] should not be concerned with the efficiency consequences of a merger. However unless the benefit-cost approach to mergers is to be abandoned altogether it is essential that the likely efficiency consequences of mergers be taken into account." (p. 45)

This comment underlines the low emphasis placed on efficiency trade-offs in the United Kingdom. Guidelines of the kind adopted in the United States also appear to be regarded with some reserve[42], although Hay and Vickers (1987) commend them for the emphasis that they place on preventing dominance. They criticise the United Kingdom and European Community policies for their relative emphasis on the effects of dominance, arguing that this leads to a costlier and less effective policy. The strength of this argument depends on the validity of classifying as abuse the practices condemned ander British and European Community legislation (such as tying, exclusive dealing and resale price maintenance). If, following developments in economic theory, fewer of these practices were to be identified as detrimental, an approach that emphasised practices while being permissive with respect to mergers could be found to be more, rather than less, cost-effective than a preventive approach, of the kind favoured by Hay and Vickers, that was less permissive of mergers and takeovers.

41 As voiced, for example, by Hay and Vickers, (1987), op.cit.

42 George, (1985) (then a member of the Monopolies and Mergers Commission) says of the 1984 United States Guidelines that they are "too all-embracing to be appropriate as a first stage screening exercise and seem to herald a much more permissive attitude towards mergers in the US" (pp 42-43).

CHAPTER THREE : NEW ZEALAND ANTITRUST POLICIES[1]

Section 1 Introduction

The Commerce Act 1986 ("the Act") came into force on 1 May 1986. It contains detailed provisions for the regulation on competition grounds of takeovers and mergers and "restrictive trade practices". These provisions are based largely on the concepts underpinning the restrictive trade practices and merger provisions of the Australian Trade Practices Act 1975.[2] The Act also provides for the imposition of price controls on particular industries following orders in council.

The major provisions of the Act give legal substance to a series of underlying economic concepts. These concepts, and the manner in which the Act is interpreted and applied, stand to have an important influence on the way in which business activity in all sectors of the economy is organised and responds to change. The quality of the interventions under the Act will have a significant effect on the overall performance of the New Zealand economy.

This economic review of the Commerce Act 1986 and the Commission's decisions under the Act is in six parts. Section 2 outlines the statutory provisions of the Act. Section 3 discusses the Commission's explicit statements of interpretation regarding the economic principles underlying the Act, the antitrust principles expressly applied by the Commission and the principles that appear to have been actually adopted by the Commission. Section 4 discusses the economic principles adopted by the High Court in its decisions made under the 1986 Act. The economic principles stated by the Commission and the High Court and their application are assessed against the economic framework outlined in Chapter One. It is argued that in several fundamental areas the principles adopted by the Commission and the High Court fall short of, or conflict with, the theoretical economic approach suggested. These comments do not necessarily imply criticism of the Commission itself or the High Court, since these bodies' decisions are framed in terms of their legal interpretation of the Act and the precedents relating to it. Conclusions are drawn in Section 6.

---

1 This Chapter draws extensively on the report "An Economic Review of Commerce Commission Decisions Under the Commerce Act 1986", prepared for the Treasury by Stephen Jennings and Susan Begg, May 1988. This was released by the Treasury following a request under the Official Information Act.

2 Vautier argues that:

"[w]hile the Australia New Zealand Closer Economic Relations Trade Agreement (ANCERTA) provided a broad rationale for aligning New Zealand's trade practice law with that of Australia (as part of a wider move towards harmonisation of commercial laws), this was apparently incidental to the government's desire to adopt Australia's 'more effective approach' to trade practice law (although there are important differences between the Australian and New Zealand Statutes)." (1987, pp 54-55)

Vautier suggests that the major differences between the Commerce Act and Australia's Trade Practices Act relate to the treatment of exclusive dealing, price discrimination and price fixing and the procedural arrangements for scrutinising mergers and takeovers.

Section 2 Statutory Provisions

This section discusses the statutory provisions provided in the Commerce Act 1986. The Act is concerned with three main areas of business activity: restrictive trade practices, mergers and takeovers, and price controls. The Act also describes the enforcement body and procedures, remedies and appeals in relation to the Act. The main statutory provisions of the Act are described below.

2.1 Restrictive Trade Practices

The restrictive trade practice provisions are aimed at preventing practices that would have an adverse impact on "competition"[3]:

2.1.1 *Restrictive Contracts and Agreements*

- the Act prohibits entering into or giving effect to contracts, arrangements or understandings which have the purpose or effect of substantially lessening competition in a market (Section 27);

- exclusionary provisions in contracts, arrangements and understandings are also prohibited (Section 29);

- collective price fixing agreements are deemed to substantially lessen competition (Section 30) and are therefore prohibited pursuant to Section 27. Prices fixed within a joint venture (Section 31) or a joint buying and promotion arrangement (Section 33) are exempt from this deeming provision. Price recommendations to a group of more than 50 persons are also exempt (Section 32). Such exempt arrangements may nevertheless contravene the Act where they have the purpose or effect of substantially lessening competition;

- resale price maintenance is prohibited and cannot be authorised by the Commerce Commission.

2.1.2 *Authorisation*

All of the above practices (apart from resale price maintenance) can be authorised by the Commission where it can be shown that they have a benefit to the public which outweighs the anti-competitive effects of the practice.

2.1.3 *Use of a Dominant Position in a Market*

The Act prohibits a company having a dominant position in a market from using that position for the purpose of:

- restricting entry into a market;

- preventing or deterring competitive conduct in a market;

- eliminating persons from a market (Section 36).

2.1.4 *Penalties for Contravention of Restrictive Trade Practices*

Contravention of the Act's restrictive trade practices provisions exposes the parties to the following penalties:

3 This summary of the statutory provisions of the Act is drawn from "Commerce Act 1986, An Outline", a pamphlet published by the Commerce Commission.

- pecuniary penalties of up to $100,000 for individuals and $300,000 for companies which may be sought by the Commission;
- private actions for damages which may be taken by persons affected;
- injunctions to halt or prevent a contravention which may be sought by the Commission or affected persons.

2.2 Mergers and Takeovers

2.2.1 *Two Part Test*

The Act provides for a two-step procedure for evaluating mergers or takeovers that exceed the threshold level of assets laid down by the Act:

- the Commission may grant a clearance to a merger or takeover proposal if it is satisfied that as a result of the merger or takeover a company would not acquire or strengthen a dominant position in a market;
- if the Commission determines that the implementation of the proposal would result in the acquisition or strengthening of a dominant position, it can only grant an authorisation where it is satisfied that there are benefits to the public that outweigh the detriment resulting from the proposal's implementation;
- merger or takeover proposals that result in the acquisition or strengthening of a dominant position in a market but which do not have countervailing public benefit will not be authorised.

2.2.2 *Penalties*

Failure to obtain approval for a notifiable merger will make participants in the proposal liable to fines of up to $300,000. The Commission may also seek injunctions to halt or prevent the implementation of the proposal.

2.3 Price Control

The Commerce Act retains the power to control the prices of particular goods or services. Such control is imposed by the Governor General by Order-in-Council on the recommendation of the Minister of Health for drugs, the Minister of Energy for goods and services in the energy sector and the Minister of Trade and Industry for all other goods and services.

2.3.1 *The Controls*

The Act makes the following provisions:

- control may be imposed only where there is limited competition in the market for the goods and services to be controlled and where control is seen by the Minister as necessary or desirable in the interests of users or consumers or, as the case may be, of suppliers;
- orders imposing price control must have a specified termination date, but control may be reimposed at that time;
- goods or services subject to control may not be sold except in accordance with a price authorisation made by the Commerce Commission. The Commission may accept price undertakings from suppliers instead of authorising a price.

2.3.2 *Penalties*

Contravention of the price control provisions of the Act may result in fines of up to $30,000.

Section 3 The Interpretation of Key Principles by the Commerce Commission

This section discusses the Commerce Commission's interpretation of the economic principles underlying the Commerce Act. Not all of the provisions of the Act have yet been applied by the Commerce Commission. The issues addressed below are, however, central to analysing whether or not the current Act is likely to be providing net benefits for New Zealand.

3.1 Objectives of the Commerce Act

In the News Limited/Independent Newspapers Limited case (Decision No 164, "**News/INL**") the Commission had "regard to the fact that the long title of the 1986 Act provides that its object is to promote competition in markets within New Zealand ..." (Decision No 164, para 6). Similarly, in the Fletcher Challenge Limited/NZ Forest Products Limited case (Decision No 213, "**FCL/NZFP**"), the Commission argued that "the purpose [of the Act] is to promote competition, so that doubts as to the necessity for such a policy are for Parliament to address" (Decision No 213, para 169).

However, the Commission has also argued (in the Weddel Crown Corporation, Waitaki International Limited and W Richmond Limited application for authorisation for a collective agreement relating to the closure of the Whakatu and Advanced Works "**Whakatu**") that the Act provides for the pursuit of other objectives under the public benefit test and that "there appears to be no limitation to the nature of public benefits which may be claimed" (Decision No 205, para 25). The Commission has also argued (in the Amcor Limited/New Zealand Forest Products Limited case "**Amcor/NZFP**") that the achievement of competition may conflict with public benefit objectives and that a judgement between the conflicting objectives might be necessary (Decision No 208, para 75).

In contrast, in the Goodman Fielder Limited/Wattie Industries Limited case (Decision No 201, "**Goodman Fielder/Wattie**"), the Commission argued that the premise of the Act is that:

> "the interaction of competitive forces will yield the best allocation of New Zealand's economic resources, the lowest prices, the highest quality and the greatest material progress etc., unless it is shown, for example, that the possession of a dominant position is better able to achieve economic efficiency." (Decision No 201, para 258)

In the recent New Zealand Co-operative Dairy Company Limited/Auckland Co-operative Milk Producers Limited ("**Co-operative Dairy**") case, the Commission emphasised the importance of economic efficiency as an objective of the Act. It noted that competition is valued as a means of promoting efficiency in resource use. The approach adopted represents a shift in the Commission's interpretations of the principles underlying the Act:

> "The Act's objective suggests that the competitive process is generally the most likely means of stimulating efficient resource use. Conventional economic theory suggests that the potential harm that arises from the absence of competition (as reflected in the definition of dominance) is that firms will have sufficient market power to restrict output and raise prices relative to competitive circumstances, and, generally, to behave in a manner unconstrained by the actions or reactions of others. In other words, from society's viewpoint, there will be a potential loss of allocative efficiency in that output will be lower than it would be in a competitive environment. A more dynamic view of the competitive process would suggest that, in the absence of competition, there is likely to be a dampening of incentives to ensure product and service quality, innovation and, generally, sound managerial performance. It is the risks of exposing those who deal with the dominant firm to the potential for unconstrained actions (and inefficient managerial performance), with consequential efficiency loss, that the Act is designed to address. In summary, dominance, by definition, creates the potential for economic harm. It is on that basis that the

Commission is required to intervene. (Decision No 216, para 8.4, "**Co-operative Dairy**")

3.2 Dominant Position: Principles

The Commerce Commission has determined that the test of a "dominant position" is essentially one of market power. In the Magnum Corporation Limited/Dominion Breweries Limited case (Decision No 182, "**Magnum/DB**") the Commission argued as follows:

> "Being in a 'dominant position' is interpreted by the Commission, in essence, as having sufficient market power (economic strength) to enable the dominant party to behave to an appreciable extent in a discretionary manner without suffering detrimental effects in the relevant market(s)." (Decision No 182, para 77)

In **News/INL** the Commission argued that although the factors listed in section 3(8) of the Act must be taken into account in assessing dominance, the list does not exclude consideration of other matters. The Commission went on to provide an expanded list of the factors that it considered might assist in assessing dominance, although it noted that the list was not necessarily exclusive of other matters that should be considered (Decisison 164, para 10):

"(i) The structure of the market which requires a consideration of:

(a) The share of the market of the merged new concern.
(b) The degree of market concentration.
(c) The size distribution of all concerns in the market.
(d) The extent to which the products in question are characterised by product differentiation and sales promotion, i.e. whether there are reasonably close substitutes.
(e) Access to technical knowledge, materials and capital.
(f) The financial stability of the merged concern in relation to other operators in the market.
(g) The nature of any formal, stable and fundamental contracts, arrangements or understandings between concerns in the market.
(h) The extent of corporate integration (e.g. interlocking shareholdings and cross-directorships) among concerns in the market.
(i) The extent of vertical integration.

(ii) The extent of restraints imposed by the conduct of competitors or potential competitors or by others affected which requires a consideration of:

(a) The extent to which competition exists or has existed and is likely to continue.
(b) The extent to which the concern is constrained by the conduct of competitors.
(c) The capacity of the concern to determine prices in or to exclude entry to the market without being inhibited in that determination or action by suppliers and acquirers.
(d) The height of barriers to entry in that market and the ability of potential competitors to enter the market and to sustain a position in the market."

In assessing dominance, the Commission noted in the Brierley Investments Limited/Petroleum Corporation of New Zealand Limited case ("**Brierley/Petrocorp**") that account must be taken of expected future changes in the operating environment of firms:

> "There is no merit in assessing markets solely in terms of the existing statutes and contracts when it is known that fundamental changes will probably occur. Indeed, the existing operating environment is relevant only to the extent that, if the proposal proceeds, the merged entity would operate within it for a relatively short time until the form of any such changes are announced or enacted." (Decision No 215, para 53)

In the **Co-operative Dairy** case, the Commission noted that:

> "no specific time dimension is suggested by the Act's definition of dominance. Thus the Act gives no guidance as to how long a dominant position might be tolerated if it were thought that competitive constraint could be exerted, but only after some time." (Decision No 216, para 8.6)

Market definition, market concentration and entry barriers are constructs that can be used to analyse market power in particular circumstances. The Commission's statements of principle regarding these are discussed below.

3.2.1 *Market Definition*

In **News/INL** the Commission noted that the "concept of a 'market' has been canvassed by the Commission in **Edmonds/Tucker** (1984), 4 NZAR 360 and explained in other cases" (Decision No 162, para 8). In **Edmonds/Tucker** the Commission argued that:

> "[a] market has been defined as a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive. In delineating the relevant market in any particular case, there is a value judgement which must be made which involves, for example, an assessment of pertinent market realities such as technology, distance, cost and price incentives, an assessment of the degree of substitutability of products; an appreciation of the fact that a market is dynamic and that potential competition is relevant; and an evaluation of industry viewpoints and public tastes and attitudes. Particularly important in this process is industry recognition (both by supplier and purchaser) and recognition by the consumer. Ultimately the judgement as to the appropriate market - and its delineation by function, product and area - is a question of fact which must be made on the basis of commercial common sense in the circumstances of each case - see for example, the United Kingdom case of **Wire Ropes** (1964) LR5 RP 146, 204."

3.2.2 *Market Concentration*

In **Magnum/DB** the Commission referred to the list of factors set out in **News/INL** which it argued may be relevant in determining whether a dominant position would be acquired or strengthened, and noted that:

> "[g]enerally it is no longer considered appropriate for such factors, notably market share, to be viewed in isolation. While it is understandable that the **presumption** of dominance increases as market share rises, it is the cumulative impact of various factors that is important in determining whether or not a dominant position would be acquired or strengthened." (Decision No 182, para 81, emphasis in original).

In **Magnum/DB** the Commission argued that high market concentration is not a sufficient condition for collusion, i.e.:

> "It is sometimes presumed that such concentration as exists in an oligopoly leads to co-operative behaviour or to interdependence in pricing and other strategic decisions that is equivalent to tacit collusion. While it is arguable that concentration or increased concentration itself might facilitate collusive behaviour, the Commission does not accept that collusion - explicit or implicit - let alone successful collusion, will necessarily follow... to assume a simple correlation between high concentration and active collusion (or effective dominance) would seem to ignore the relevance of other market conditions (e.g. access of third party competition) in determining whether or not cartel-type behaviour is likely to succeed. As a safeguard, specific provisions exist in Part II of the Act in respect of collusive practices between competitors. In the Commission's view, it is this question of (unlawful) collusion, rather than market

concentration per se, that is the appropriate focus of a competition law, especially one with stronger and more comprehensive restrictive trade practice provisions than have previously existed in New Zealand legislation." (Decision No 182, paras 79-80)

3.2.3 *Barriers to Entry and Potential Competition*

The Commission stated in the list provided in **News/INL** that "the height of barriers to entry ... and the ability of potential competitors to enter the market and to sustain a position in the market" (Decision No 164, para 10) are among the factors to be considered in assessing dominance. Entry barrier and potential competition concepts were also canvassed in the New Zealand News/New Plymouth Star case (Decision No 176 , "**NZ News/NP Star**"), viz:

> "These considerations of ease of entry, having regard to relevant structural and behavioural aspects of the market, which we discussed in News Ltd/INL (Decision No 164), are pertinent to the Commission's deliberations on market dominance... It is the absence, in this case, of any significant constraints on **de novo** entry or on the ability of existing operators to expand their operations which gives substance to the view that potential competition will serve as a discipline on INL's pricing behaviour and on the level and quality of service it provides. It would, in the view of the Commission, be relatively easy for others to enter the market particularly if INL were to abuse its position. This view has been reached after a careful examination of the facts involved and a weighing of probabilities based on those facts." (Decision No 176, para 16)

The impact of advertising as an entry barrier was discussed by the Commission in the Dunlop New Zealand Limited/Goodyear New Zealand Limited Case (Decision No 204, "**Dunlop/Goodyear**"):

> "Advertising would be unnecessary under conditions of perfect competition - where products are assumed to be homogeneous. However, in the real world, products and services are differentiated and consumer knowledge of the differences (real or imagined) is enhanced by promotional expenditure. While such expenditure might be regarded by a prospective entrant as a significant entry cost, it does not represent an artificial entry barrier, nor a cost that is confined to potential competitors as distinct from existing market incumbents. Furthermore, advertising does not represent market power; the advertising market itself is accessible." (Decision No 204, para 32)

3.2.4 *Vertical Integration*

In **Dunlop/Goodyear**, the Commission detailed the principles it believed should be applied in determining whether vertical mergers result in the acquisition or strengthening of a dominant position. The Commission noted the discussion and conclusions of the High Court in the **Fletcher Metals Ltd v Commerce Commission** case [1986 6 NZAR33] in which the High Court "accepted the widely held conclusion that there is no 'necessary connection between vertical integration and monopoly power'" (Decision No 204, para 14). The Commission went on to spell out three circumstances, taken from the United States Department of Justice 1984 Merger Guidelines, in which a vertical merger might create competition problems, viz:

"1. Vertical integration may raise entry barriers in the relevant industries if a potential entrant must contemplate fully integrated entry instead of entry at only one stage of production.

2. Firms in an industry with relatively few competitors may integrate forward into retail distribution in order to enforce collusive agreements that otherwise could not be enforced because of secret price cutting.

3. A firm subject to public utility regulation (a form of price control) in one industry may integrate with a supplier in order to shift the focus of the

profits from its basic industry to the unregulated upstream industry." (Decision No 204, para 36)

The Commission went on to expand on the conditions necessary for the first of these situations to apply:

"The Commission, in elaborating upon the circumstances whereby vertical integration from a vertical merger might create 'competitively objectionable barriers to entry', now adopts the [1984] US [Merger] Guidelines in this respect. The Guidelines state that three conditions are necessary before the problem is raised. For convenience, we paraphrase them here:

(a) First, the degree of upstream or downstream vertical integration between two functional markets must be so extensive as to cause entrants to the 'primary market' (i.e. the market in which the competitive impact is being considered) to enter simultaneously the adjacent 'secondary market'. In short, this condition focuses on the issue of 'two-level entry'.

(b) The second necessary condition requires that the need to enter at the secondary level makes entry by others to the primary market significantly more difficult and hence less likely to occur. In short, this second condition focuses on the increased difficulty by others of simultaneous entry of both markets.

(c) Thirdly, the structure and other characteristics of the primary market must be otherwise so conducive to 'non-competitive performance' that performance would be likely to be affected by any raising of entry barriers. In other words, the third necessary condition focuses upon the pre-existing structure and performance of the primary market, and recognizes that the raising of entry barriers as a result of a vertical merger could, but need not, result in a loss of effective competition in the primary market having regard to the pre-existing market circumstance.

In conclusion, the Commission adopts the analytical framework described as appropriate for its assessment of vertical mergers. This framework makes it clear that certain conditions are necessary to raise competition concerns in relation to vertical integration; however, the mere presence of these three conditions is not necessarily conclusive that dominance is acquired or strengthened. The framework also allows any pro-competitive effects of a vertical merger to be recognized." (Decision No 204, para 37)

In the Eachiarn Investments Limited/Fluid Control (NZ) Limited case (Decision No 214), the Commission reiterated the vertical integration principles set out in **Dunlop/Goodyear** and rejected market foreclosure *per se* as a relevant consideration in assessing dominance (Decision No 214, para 31).

3.2.5 *Bare Transfer of Monopoly Power*

In the Welgas Holdings Ltd/Auckland Gas Company Limited case (Decision No 209) the Commission argued that the Act is not concerned with the "bare transfer of monopoly power" (i.e. where a corporate control transaction shifts monopoly power from one entity to another without strengthening that power) and that to do so could involve economic costs (Decision No 209, para 10).

3.2.6 *Dominance and Price Controls*

The Commission rejected the proposition made in the **Brierley/Petrocorp** case that a firm that was subject to price control was not "dominant" because it did not have the power to raise prices. Instead the Commission suggested that the existence of such controls was evidence that the company had market power (Decision No 215, para 48).

In contrast, the Commission briefly discussed price controls in discussing competitive detriment in the **Co-operative Dairy** case. It noted:

> "an industry could be under actual price control or the threat of price control, in which case it would not be unconstrained in its pricing." (Decision No 216, para 8.6)

3.3 Dominant Position: Practice

The market analysis concerning dominance in the **News/INL** and **Magnum/DB** decisions accurately reflects the explicit principles set out by the Commission in those landmark cases. In particular, the Commission focused on the factors tending to limit market power rather than on other potential outcomes or structural features of the market (see for example Decision No 182, para 94).

The market analysis in the majority of the Commission's minor merger and takeover decisions has also been directed by the underlying concern with market power.

In several of the minor merger and takeover cases the Commission has adopted a fairly permissive interpretation of dominant position. A good example of this is the Robertshaw Controls (NZ) Ltd/Repco Controls NZ Ltd merger case (Decision No 181) in which the participants respectively supplied 40 percent and 60 percent of the "market" concerned. The Commission granted clearance despite the fact that it recognised that "the proposal would create a substantial aggregation of market share in three products" (para 12).[4] In giving clearance, the Commission noted that the merged party would be constrained by the potential for imports (Decision no 181, para 12). This conclusion was reached even though the Commission recognised that "in percentage terms imported products would be much higher [in price] than those manufactured locally" (Decision No 181, para 8).

The disciplining role of potential competition was recognised by the Commission in the Fletcher Building Products Limited/UEB Industries Limited case (Decision No 177). In that case the Commission initially expressed concern regarding the 60-70 percent share the merged entity would have in the "market" for the manufacture of hollow core doors. In its final decision the Commission concluded that Fletchers would be constrained by imports and the potential for new entry into the market (Decision No 177, para 31).

The approach in these minor cases contrasts with the Commission's more restrictive interpretation of dominant position in some of the major takeover and merger cases discussed below. In several of those major cases, the Commission's analysis was based on principles (usually implicit) which depart significantly from those outlined in Section 3.2. The most marked of these departures involve the following issues:

- concern with market structure *per se* and the inability of inefficient firms to compete;
- incorrect analysis of excess capacity;

---

4 The Commission estimated that the "market share" of the merged entity would be 98 percent in low pressure gas heaters, 68 percent in low pressure electric heaters, 90 percent in boiling units and 100 percent in dairy heaters.

- incorrect analysis of vertical integration;
- unfounded concerns regarding predatory pricing and cross-subsidisation;
- insufficient weight to import competition; and
- incorrect market definition.

The problems with the Commission's analysis of each of these issues are illustrated below.

3.3.1 *Concern with Market Structure* Per Se *and the Inability of Inefficient Firms to Compete*

In a number of instances in the **Goodman Fielder/Wattie** Decision the Commission was critical of the merger proposal, either expressly or implicitly, on the grounds that the merger parties had efficiency advantages over their competitors or because of the synergies which would arise from the merger itself.

The Commission noted that the GFL/Wattie mills would incur substantial transport cost savings in handling wheat (para 117); the competing firm Ireland would not be in the same position as the merged GFL/Wattie mills in obtaining transport cost savings (para 134); imports of flour would be at the expense of independent mills (para, 143); and Ireland would not have the resources nor the technical ability to compete with GFL/Wattie mills (para 145). In reviewing the South Island mills the Commission appears to have placed a lot of weight on the numbers of actual firms in the marketplace rather than on tests of market power (see paras 160, 163-165, 168-169 and 173-174).

3.3.2 *Incorrect Analysis of Excess Capacity*

In its market share analysis in **Goodman Fielder/Wattie** the Commission focused on current production and ignored productive capacity. Based on the productive capacity of each New Zealand flour mill and a production schedule of 116 hours per week for 48 weeks a year (i.e. the optimal level of plant utilisation) the merger parties estimated that the flour milling industry had 40 percent excess capacity, 68 percent of which was held by parties other than Goodman Fielder/Wattie. The merger parties argued that mills independent of the merged entity would therefore have the capacity to supply 78 percent of New Zealand's flour consumption.

Mainstream thinking on market definition holds that for goods, such as flour, which are sold primarily on the basis of price for standardised levels of quality rather than on the basis of recognised brand names, it is desirable to measure market shares on the basis of capacity rather than output. This reflects the competitive constraint imposed by producers who are able to expand output in response to a price increase. This approach is consistent with the United States Merger Guidelines which note that if firms have capacity that could be brought into production within one year they should be included in the market.[5]

In its only significant discussions of excess capacity the Commission implied that excess capacity acted as a barrier to new market entrants (Decision No 201, paras 147 and 148) and was likely to hasten the demise of small independent mills (Decision No 201, para 163).

3.3.3 *Incorrect Analysis of Vertical Integration*

In the New Zealand Forest Products/UEB Industries Limited case (Decision No 199, "NZFP/UEB"), **Goodman Fielder/Wattie, Amcor/NZFP** and **FCL/NZFP** merger cases the

---

5 US Department of Justice 1984 Merger Guidelines, Section 2.21.

Commission analysed the competition impact of vertical integration in a manner that deviated from, or incorrectly applied, the vertical integration principles laid down in **Dunlop/Goodyear**, and foreshadowed in Wattie Industries Limited/General Foods Poultry Limited (Decision No 189).

In its analysis of the kraft paper and paperboard markets in the **NZFP/UEB** merger case the Commission concluded that dominance would be strengthened by the vertical integration of NZFP and UEB because a prospective new entrant would find it more difficult to enter the market (Decision No 199, para 72). The Commission did not ask whether the vertical integration would require a new entrant to enter at two levels of the market rather than one (as it outlined in its statement of principles).

In the **Goodman Fielder/Wattie** merger, vertical integration between bread baking and input markets (flour and yeast) was an important theme underpinning the Commission's findings of dominance in the bread baking, flour and yeast markets. In the case of the flour market the Commission argued that the concentration of a merged Goodman Fielder/Wattie and their control of flour-using outlets would deter a new entrant into flour milling.

However (applying the framework outlined in **Dunlop/Goodyear**), the vertical integration between flour milling and breadmaking would not require a new flour miller to simultaneously enter bread baking. The merger would not have affected the ability of Goodman Fielder/Wattie to supply all of their flour requirements internally. On the basis of the Commerce Commission's figures, 48 percent of the bread baking market would have remained outside Goodman Fielder/Wattie ownership following implementation of the initial merger proposal (the comparable figure provided by the merger participants was 55 percent). Considerable scope would therefore have remained for the establishment of new domestic flour producers and/or flour importers.

In **Brierley/Petrocorp**, the Commission claimed that the combining of the wholesale and retail levels of the gas industry would result in "a substantial aggregation of market power" (Decision No 215, para 55); it did not explicitly apply the test it adopted in **Dunlop/Goodyear.** The Commission claimed that barriers to entry would be raised by the vertical integration but did not discuss this in terms of the need for two-level entry.

3.3.4 *Unfounded Concerns Regarding Predatory Pricing and Cross-Subsidisation*

In a number of merger or takeover cases the Commission has based its findings of dominance on the possibility of predatory strategies, frequently involving cross-subsidisation, by the merger parties. The Commission has not made any explicit statements of principle concerning predatory pricing. Invariably, the Commission's arguments regarding predation have involved loose implicit theorising and have not been based upon any rigorous analysis of the incentives for, or likelihood of, predation in the markets concerned.

In **Goodman Fielder/Wattie** the Commission argued that its South Island mills could set prices such that competitors would be threatened (paras 166 and 173). However, a close examination of the markets concerned reveals that predatory pricing would be unlikely to be a successful strategy. Predatory pricing by Goodman Fielder/Wattie would have involved pricing below average variable cost and incurring losses on every unit sold. Goodman Fielder/Wattie would have increased its market share, thereby increasing the overall size of its loss.

If this was to be a profitable strategy, the monopoly profits earned once competitors were driven from the market would have had to exceed in present value terms the losses initially incurred. To be completely successful as a predator Goodman Fielder/Wattie would have had to force the closure of eight separate mills (all of which had survived five months of deregulation at the time of the Commission's decision) which together are capable of satisfying the South Island's flour consumption 2.8 times over.

Further, the plant and equipment of any participants forced to shut down would still have been in place and could have been bought back into production if Goodman Fielder/Wattie raised its price above competitive levels. This would apply even if the firms themselves went bankrupt. The new owners of the plant would be in a position to re-enter the market at some time in the future.

3.3.5 *Insufficient Weight to Import Competition*

In a number of decisions the Commission has given little weight to the competitive discipline posed by imports in situations where imports have either gained a small but significant market share or clearly impose a ceiling on domestic prices.

In **NZFP/UEB** the Commission found that the merger would strengthen dominance in the kraft paper and paper board markets even though it noted that the removal of import barriers was exposing NZFP to greater competition. It observed that the threat of imports already provided a constraint:

> "The absence of effective competition has allowed NZFP to price up to the level at which kraft paper and paperboard could be imported duty-paid from the USA (as the attached Appendix 2 [of the Commission's decision] shows)." (Decision No 199, para 17)

In such a situation, actual and potential imports impose an effective and declining ceiling on domestic prices. It is the explicit purpose of a tariff to allow a domestic producer to price up to the landed price of imports. Competition policy should not be employed to thwart this ability. Because UEB was already pricing to the limit imposed by imports, its pricing discretion in the kraft paper and paperboard markets would not have been enhanced through a merger with another domestic kraft paper and paperboard manufacturer.

In **Goodman Fielder/Wattie**, the Commission rejected Australian flour imports as a constraint on New Zealand flour millers because of the costs of transporting flour to the North Island from Australia. This conclusion ignored the rapid removal of quota restrictions and the low CER tender premium on Australian flour imports. This evidence implies that it is feasible to profitably import flour into New Zealand. The Commission also ignored considerable market evidence on small volume flour imports and the widespread recognition by market participants (including those opposed to the merger) of the threat posed by Australian flour imports.

In **Goodman Fielder/Wattie** the Commission also found dominance in the "frozen pastry and pastry products markets" (para 246). This conclusion was made even though the Commission accepted that in the case of frozen pies "the lowering of import barriers has resulted in a steady increase in market shares of overseas products" (para 238). In the case of pastry, it noted that "there has been some import competition for frozen pastry from Australia" (para 242). In its summary on dominance the Commission concluded that "import competition for frozen pastry products has increased significantly as frontier protection has been dismantled" (para 245). The Commission's conclusion of dominance gave insufficient weight to the constraint imposed by imports and the potential for these to increase further in response to an increase in domestic prices.

3.3.6 *Incorrect Market Definition*

In a number of cases the Commission has taken a narrow approach to market definition and excluded from consideration matters which would provide some constraint on the exercise of market power. There is a tendency for the Commission to seek products that are perfect or very close substitutes to the product in question, ignoring the constraints that "imperfect" substitutes might impose. This approach would be satisfactory if market disciplines ignored during the market definition/market share exercise were allowed for in the analysis of entry barriers. However, if a product or geographic area is considered to be "out" of the market, it

is often given no or insufficient further consideration by the Commission. As a result, important constraints are sometimes ignored by the Commission in assessing market power. Most products are differentiated and firms have some degree of market power. The issue is the extent of market power and the disciplines imposed in the market by other players, rather than whether or not any market power at all exists.

In **NZFP/UEB** the Commission noted that substitute products would place some constraint on paperboard manufacturers. In assessing dominance, though, no weight was given to those substitutes (Decision No 199, para 61).

Similarly, in **Brierley/Petrocorp** the Commission accepted that in some circumstances substitute products for gas would act as a constraint on organisations selling gas to industrial users. However, the Commission concluded that the market should be defined as the gas market and no further consideration was given to the constraints imposed by substitutes.

In **Goodman Fielder/Wattie** the Commission concluded that the North and South Islands were separate geographic markets on the grounds that there were "distinct and high costs" (para 109) incurred in inter-island flour transport and that the flow of inter-island flour is "likely to reduce significantly further" (para 116).

In drawing this conclusion the Commission failed to ask the question: how would South Island millers respond to a small but non-transitory increase in North Island flour prices? Even at the then existing price relativities, 10 percent of North Island flour consumption was met by South Island flour (using the Commission's figures). Given the considerable excess capacity of South Island mills any small but non-transitory rise in North Island flour prices would have been likely to have resulted in increased inter-island flour trade.

In a number of other cases, the Commission has adopted a market definition that appears to be consistent with broadly accepted principles. Instead of determining whether an area or product is "in" or "out" of the market, the Commission has focused on the market constraints on the entities concerned. For example, in **NZ News/NP Star** the Commission noted that although its attention was primarily focused on the provision of news and advertising services in the print medium in North Taranaki, it accepted the appropriateness of a wider perspective which recognised a broader range of advertising outlets. Similar approaches were adopted in **News/INL** and Independent Newspapers Ltd/Thames Valley News Ltd (Decision No 180).

3.4 Substantially Lessening Competition

The Commission's interpretation of "substantially lessening competition" was discussed at length in **Whakatu.**

In the **Whakatu** case the Commission argued that the agreement (to close the Whakatu works) would strengthen market power so that the test of substantially lessening competition had been met (Decision No 205, paras 51 and 54). The Commission's focus on market power in applying section 27 is consistent with the explicit statements of principle adopted by the Commission in **Whakatu**.

A problem with the Commission's analysis is its focus on the "combined capacity and market share" of the participants. At no stage in **Whakatu** does the Commission consider the division of capacity between the participants. Unless a general collusive agreement was expected to follow from the closures (which the Commission did not argue), the key issue to be determined was the degree of market power of the individual companies resulting from the closure. The facts presented in Whakatu suggest that any increment in the market power of the participants would have been negligible. This was effectively accepted by the Commission when it noted that "[t]he agreement which is the subject of this case does not prevent or inhibit future competition between the applicants and there is no evidence that

the opportunity for competition to occur in the defined market does not exist" (Decision No 205, para 58).

Under these conditions, it seems unlikely that the **Whakatu** agreement would have enhanced the market power of the parties to that agreement or resulted in losses in allocative efficiency.

3.5 Relationship Between Substantially Lessening Competition and Dominant Position

In **Magnum/DB** the Commission argued that:

> "[a]lthough the general purpose of the Act is to promote competition in markets within New Zealand, lessening of competition in a market, even a substantial lessening, is not sufficient reason for the Commission to decline a clearance to a merger or takeover proposal." (Decision No 182, para 77)

In **Whakatu** the Commission argued that the "low competition threshold [for substantially lessening competition] is for the purposes of determining jurisdiction and enforcement" (para 24). The Commission noted that it:

> "considers it proper to draw attention to Parliament's adoption of what appears to be a relatively low competition threshold for the purposes of determining jurisdiction and enforcement [under section 27]." (Decision No 205, para 24(iii))

The Commission has therefore clearly determined that "substantially lessening competition" involves a lower competition threshold than "dominant position".

The Commission's application of the "substantially lessening competition" and "dominant position" tests has been consistent with its explicit acceptance of a lower competition threshold for substantially lessening than for dominance.

3.6 Public Benefit

The Commission has interpreted public benefit widely. The benefits accepted have included both efficiency and income distribution issues. The Commission has been concerned with the distribution of the benefits and has weighted them according to who has received the benefits. The Commission has therefore been concerned with income distribution considerations in many of its decisions.

3.6.1 *Benefits Accepted by the Commission*

- economic efficiency (**Goodman Fielder/Wattie**, para 257);
- enhanced export potential and international competitiveness (**Goodman Fielder/Wattie**, para 267, 278); (**Amcor/NZFP**, paras 55, 70); (**FCL/NZFP**, para 157);
- rationalisation of excess capacity (**Whakatu**, para 64);
- enhanced consumer choice and employment opportunities resulting from new investment (**Amcor/NZFP**, paras 58, 61);
- savings in overheads (**Amcor/NZFP**, para 65), (**FCL/NZFP**, para 159);
- forest management and harvesting synergies (**FCL/NZFP**, para 160);
- technical and marketing economies (**FCL/NZFP**, para 162);

- improved public safety and lower maintenance on public roads (**FCL/NZFP**, para 163);
- utilisation of New Zealand resources (**Amcor/NZFP**, para 58);
- boost to employment and general economic prospects of Northland region (**Amcor/NZFP**, para 61);
- allocative efficiency enhanced by the vertical integration of two successive monopolies (**Brierley/Petrocorp**, para 58);
- efficiency gains from rationalisation (**Co-operative Dairy**, para 15.1).

The majority of the arguments accepted by the Commission as providing public benefits are conceptually consistent with the objective of maximising economic efficiency. In several instances, however, the Commission seems to have accepted as an objective the increased utilisation of New Zealand resources rather than the increased efficiency of resource utilisation, as in the **Amcor /NZFP** decision (para 58). These arguments are based on "think big"-type misconceptions regarding resource utilisation rather than rationalisation/synergy benefits that would improve the efficiency of resource use.

3.6.2 *Distribution of the Benefits*

The Commission has made the following comments about the distribution of the benefits:

- "public" is in contra-distinction to a purely private interest (**Whakatu**, para 25);
- it is desirable to demonstrate which sections of the public will benefit. Weighting given to different sections may vary (**Amcor/NZFP**, para 53);
- where benefits go to the company and shareholders and detriments to the wider public, the Commission may weight accordingly (**FCL/NZFP**, paras 167-169);
- weight attached to benefits will depend on the extent to which they are passed on to consumers (**Goodman Fielder/Wattie**, para 267);
- benefits must flow to the New Zealand public (**Amcor/NZFP**, para 53).

In many instances the Commission has given little weight to claimed public benefits on the grounds that the benefits would have been unlikely to flow to the consumers in the markets most directly affected.

For example, in **FCL/NZFP** the Commission made the following comment concerning efficiency gains accruing to shareholders:

> "[T]he claim is made that when this is taken into account 'New Zealanders' will in some way benefit as the merged entity prospers. While the Commission accepts this submission, it believes that, in the absence of competitive forces, the cost savings are less likely to be passed on to the consumer." (Decision No 213, para 161)

In the **Goodman Fielder/Wattie** case the Commission argued that the benefits of head office rationalisation of the merged concern would accrue to Australia and not to New Zealand and should therefore be discounted (Decision No 201, para 268). However, the great majority of Wattie and a large proportion of Goodman Fielder was owned by New Zealand citizens. Further, regardless of the shareholding structures of the merger parties, the cost savings arising from such rationalisation apply to Goodman Fielder/Wattie jointly.

A change in the Commission's approach to public benefit is apparent in the recent **Co-operative Dairy** decision. The Commission explicitly rejected a distributive role for the Commerce Act:

> "The Commission also accepts that detriments and benefits may impact on different groups... *The Act sets no distributive standard* and does not therefore require the Commission to deny a public benefit claim simply because participants cannot prove that it will necessarily flow to particular groups of the public and, in particular, to those consumers who, potentially, could be adversely affected by the acquisition or strengthening of dominance. To suggest therefore that a public benefit claim should be discounted because there is no competitive pressure to ensure that it will be passed on to a particular group of consumers, would unduly prejudice a proposal. As it happens, in this particular case, the Commission is in no doubt that the prospect of reducing costs to the extent envisaged, carries with it the prospect of benefit to consumers of milk/milk products." (Decision No 216, para 14.27, emphasis added).

3.6.3 *Standard of Proof*

The Commission has made the following comments on the required standard of proof:

- claims should be reasoned and specific and not simply conclusory or general statements (**Amcor/NZFP**, para 53);
- the onus to prove public benefit rests on the applicant (**Goodman Fielder/Wattie**, para 264 and **Whakatu**, para 25);
- the applicant must show that the benefit outweighs the detriment shown to exist (**Goodman Fielder/Wattie**, para 264).

In applying the public benefit provisions of the Act the Commission has generally adhered to the high onus of proof that it adopted in **Goodman Fielder/Wattie**, **Whakatu** and **Amcor/NZFP**. In the **Goodman Fielder/Wattie** case the Commission rejected the public benefits claimed relating to economies of scale (paras 269, 274), improved ability to compete with imports (para 276) and distribution savings and product rationalisation (para 277), on the grounds that insufficient evidence was provided to establish their likelihood. Similarly, in **FCL/NZFP** the Commission rejected the argument that the merger would release sufficient resources to enable the reconsideration of the case for the establishment by Tasman Pulp and Paper of a fourth newsprint machine, and thereby generate public benefits.

In several instances, however, the Commission has rejected public benefit claims through poor analysis, rather than lack of empirical evidence. For example, in **Goodman Fielder/Wattie** and in **Brierley/Petrocorp** the Commission argued that the benefits from the merger could be achieved through other forms of cooperation (para 267 and para 58 respectively). Such a statement reflects a fundamental misunderstanding of commerce and of the general reasons for a large proportion of economic activity being conducted through organisations rather than cooperative ventures. Cooperative ventures necessitate the formalisation of relationships through contracts because of the divergent interests of the parties involved. Any contract involves significant costs in preparation, negotiation and in enforcing contractual obligations. At the same time, some flexibility is required to allow each party to react to changing market conditions in the manner most favourable to them. The costs of preparing and enforcing contracts and those costs associated with any residual "hold-up" problem[6] are often reduced by merging.

---

6 For a discussion of hold-up problems, see Klein, Crawford and Alchian, (1978).

Serious contracting problems may have been raised by any significant joint venture between Goodman Fielder and Wattie to promote exports. These problems would have included disputes over brand selection, funding of distribution companies, and establishing priorities for different products.

The rejection of the benefits arising from rationalisation of the head office of the merged Goodman Fielder/Wattie was also a result of incorrect analysis. As discussed earlier, benefits would accrue to New Zealanders via their shareholdings in the merged company.

3.7 Measuring Competitive Detriment and Lessening in Competition

In considering the authorisation of takeover and merger proposals under section 66(8), the Commission is required to have regard to "any detriment to the public which would result or would be likely to result". **Goodman Fielder/Wattie** was the first merger or takeover case in which the Commission considered the nature of the detriment arising from the acquisition or strengthening of a dominant position. In that case the Commission simply argued that the participants had not established sufficient benefits to outweigh detriments (Decision No 201, para 281).

The detriment arising from the acquisition or strengthening of a dominant position was also considered in **Amcor/NZFP**. No explicit statements of principle concerning detriment were made in that case, and the analysis of detriment focused on the loss of competition the Commission found would follow from the proposal. Similarly, in **FCL/NZFP**, the Commission concluded that it "does not consider that the public benefit arguments, so diligently put by the applicant, justify the acquisition of a domestic monopoly in the market in question" (Decision No 213, para 169).

In **Co-operative Dairy**, the Commission spelled out its principles in relation to measuring detriments. It noted:

> "while the Commission accepts... that dominance is itself in conflict with the Act's competition objective... it does not accept that the matter rests there. There appears also to be a burden on the Commission to assess, as far as practicable, the degree of competitive detriment likely to flow from the acquisition or strengthening of a dominant position." (Decision No 216, para 8.5)

and:

> "application of the authorisation test should therefore, as far as practicable in each case, involve an assessment of the likely degree of detriment, arising from the acquisition or strengthening of dominance. By and large, such an assessment will be concerned with trying to define the time or other limits within which the effects of dominance could be felt, but beyond which a dominant firm could reasonably be expected to be constrained in its use of market power." (Decision No 216, para 8.7)

Section 61(6) of the Act requires the Commission to consider the "lessening in competition that would result, or would be likely to result or is deemed to result" in deciding whether to authorise trade practices that contravene Section 27. In **Whakatu** the Commission argued that:

> "the Act is worded broadly and *there appears no limitation as to the nature of* public benefit which may be claimed, nor indeed the *competitive detriment to the public flowing from the lessening of competition.*" (Decision No 205, para 25(i), emphasis added)

and:

> "[T]he test in s.27 [i.e. the substantially lessening competition test] is for the purposes of ascertaining jurisdiction. For the purposes of s.61(6) it is necessary to take into account the extent of the actual or likely lessening of competition and to assess the effects following therefrom." (Decision No 205, para 55)

The Commission notes that it "has attempted to delineate the likely detriments from the strengthening of dominance... it has not simply assumed that these would be unlimited, either in extent or duration" (Decision No 205, para 8.18).

The reference to "competitive detriment" in the first of these quotes implies that the Commission considers the "lessening of competition" test to be synonymous with the "detriment" criterion in the authorisation test for takeovers and mergers. In **Whakatu** the Commission also argued that it is "necessary to establish the actual degree of market power flowing from the practice" in determining whether there is a benefit to the public which would outweigh the lessening in competition and that "'effective competition' is consistently applied throughout the Act" (Decision No 205, para 24(vi)).

The Commission therefore appears to be arguing that, for authorisation purposes, the same criterion should be used in assessing the "harm" arising from a practice that has the effect of substantially lessening competition and that resulting from the acquisition or strengthening of a dominant position, i.e. sections 61(6) and 66(8) respectively.

3.8 Balancing Detriment to the Public and Lessening in Competition Against Benefit to the Public

Sections 61(6) and 66(8) of the Act require the Commission to weigh public benefits against competitive detriments in considering the authorisation of trade practices that contravene Section 27 and mergers or takeovers that contravene Section 66(7), respectively. The balancing of detriment to the public and benefit to the public under Section 66(8) was first canvassed by the Commission in **Goodman Fielder/Wattie**. The Commission stated that the evidential onus of proving that the public benefit outweighed the detriment rested on the applicants (Decision No 201, para 264).

In the **Amcor/NZFP** merger the Commission argued that while it was not easy to choose between the policy of fostering domestic competition and public benefit, once dominance had been found the onus of proof appears to be on the applicants to show that benefits outweigh the detriments (Decision No 208, para 75).

Whakatu was the first case in which the Commission discussed the nature of the balancing exercise between lessening in competition and benefit to the public under Section 61(6) of the Act. In that case it merely noted that:

> "[f]or the Commission to balance public benefit flowing from the agreement against the degree of lessening of competition caused by the practice, it will clearly be of assistance to test the detriment to the public arising from the lessening of competition against the benefit found. Such balancing of benefit and detriment flowing from the agreement enables a judgement to be made as to where the public interest lies - between the desirability of encouraging competition and the fostering of other public benefits seen to flow from the practice." (Decision No 205, para 25)

In balancing benefit and detriment to the public in **Goodman Fielder/Wattie** the Commission merely argued that participants had not proved benefits sufficient to outweigh detriments (Decision No 201, para 281).

In **Amcor/NZFP** the Commission stated that it "was impressed by the benefits" which were likely to flow from the proposal but that it "was concerned at the likely degree of detriment from the dominance in the kraft paper market and the potential for dominance in the

corrugated market" (Decision No 208, para 76). The Commission concluded that on balance it was not satisfied that the public benefit outweighed the detriment.

In **Whakatu** the Commission concluded that public benefit outweighed the lessening of competition. The Commission found that the competitive detriments arising from the agreement were limited and that the agreement appeared to have some pro-competitive effects (para 69).

In **Co-operative Dairy** the Commission found that:

> "In this case, not to allow the merger to proceed would, in effect, serve to raise the participants' costs substantially above what they could otherwise be. Allowing for the detriment found, the Commission concludes that the merger would be likely to make a net positive contribution to public benefit through enhanced economic efficiency and as a result enhanced consumer welfare." (Decision no 216, para 15.2)

The Commission's treatment of the balancing exercise in **Goodman Fielder/Wattie** and **Amcor/NZFP** reflects the weaknesses in the Commission's analysis of "detriment to the public" and "public benefit" which follow from the Commission's failure to focus on the efficiency effects of particular proposals. Given the manner in which the Commission has interpreted and applied "detriment to the public" and "public benefit", its analysis is biased (from an efficiency perspective) towards excessive intervention.

Section 4 High Court Decisions

4.1 Dominant Position

The judgment of Barker J. in Auckland Regional Authority (ARA) v Mutual Rental Cars (Auckland) Limited & Ors ("**Budget**", Unreported, High Court, Auckland Registry, CP 1373/86, 31 July 1987) was the first High Court case in which the issue of dominance was considered. Barker J. quoted with approval the definition of a dominant position contained in a decision of the European Court (**Re Continental Can**). The European Court noted:

> "Undertakings are in a dominant position when they have the power to behave independently, which puts them in a position to act without taking into account their competitors, purchasers or suppliers. That is the position when, because of their share of the market, or of their share of the market combined with the availability of technical knowledge, raw materials or capital, they have the power to determine prices or to control production or distribution for a significant part of the products in question." (Budget, p 76)

Barker J. did not make reference to the principles adopted by the Commerce Commission in **News/INL** or **Magnum/DB**. He concluded that on the facts ARA was in a dominant position in the market for concessions for rental operations at the Auckland airport and the market for hiring of rental cars at that airport.

The second court case considering the issues of dominance resulted from the judicial review of the Commerce Commission's decisions in **Magnum/DB**; Lion Corporation Limited v Commerce Commission ("**Lion/Commission**", unreported, High Court, Wellington Registry, M 666/86, 27 November 1987). After quoting the **Continental Can** passage, Davison, C. J. noted that he had little doubt that the provisions of the Commerce Act were modelled substantially upon the decision of the European Court in **Re Continental Can**. He stated that the Commission had given the same meaning to the word in its interpretation of the statute, and that it was not mistaken to do so.

Davison C.J. interpreted "market power" in terms of market share, ignoring other considerations such as potential entry:

> "Market power and economic strength are matters referred to in para (a) [S 3(8) (a) of the Act] which speaks of the share of the market, technical knowledge, access to materials or capital." (p 15)

The issue of dominance was only briefly canvassed in another decision of the High Court, **Tru Tone Limited & Ors v Festival Records Retail Marketing Limited** ("**Festival**", unreported, High Court, Auckland Registry, CL 31/87, 7 February 1988). In that decision the Court appears to have assessed dominance in terms of market share alone. It noted that Festival Records had less than one fourteenth of the relevant market and that "it hardly needs to be said that such a small percentage of a total market is quite insufficient to give a party dominance" (p 19). The decision did not consider any principles of market dominance.

4.1.1 *Market Definition*

In the **Budget** case, Barker J. claimed that the assessment of the market was a factual one:

> "The reference to the market as a matter of fact and commercial common sense makes the defining of a market a 'jury question'. The Judge must make his assessment aided by the evidence, including the expert evidence." (p 65)

He also suggested that it would be helpful to draw on experience in Australia in defining the market. However, in Australia, market definition exercises have not followed a "jury approach".

In discussing market definition Barker J. quoted the passage from **Edmonds Food** (also adopted by the Commission) and noted that the **Queensland Co-operative Milling Association** case ("**QCMA**") provided the "classic statement about market structure". Barker J. appears to have confused market definition with market structure in that statement. In the context of a discussion of market definition, Barker J. inappropriately quoted the passage in the **QCMA** decision that describes competition as a process instead of the well known passage on market definition.

Barker J. introduced a concept of "sub-markets" into his discussion of the rental market. He suggested that the rental car market could be divided into the business market, the tourist market, and the non-business market. He quoted with approval the **Re Tooth & Co Ltd** (1979) decision that stated the following:

> "The judgment makes it clear that the market is not necessarily homogeneous, it may include sub-markets; it does not have neat boundaries." (p 55)

In assessing whether Auckland airport was a separate market from the national market, Barker J. quoted the following statement made by Dr Bollard:

> "As to whether you would call Auckland airport a separate market from the national market, to an economist this would depend on whether there are identical characteristics of demand or supply in that market... Auckland airport is a differentiated sub-market." (p 69)

The approach adopted by Barker J. resulted in his ignoring the constraints on the exercise of market power imposed by substitutes for car hire from an airport booth. Any options deemed to be outside the sub-market were effectively ignored.

A similar market issue was raised in the Compass Tax and Duty Free Shopping Limited vs Miles DFS & Ors ("**Compass**", unreported, High Court, Auckland Registry, CP 440/87). In commenting on whether Auckland airport constituted a separate market for duty free goods or was part of the larger Auckland market, Wylie J. noted that it would be inappropriate for him to resolve this question (p 14). However, in discussing the applicant's operations he made the following comment:

> "All of that [information] does not convey the impression of an insignificant operation of the applicant which is unlikely to have any influence on the duty free market in Auckland (whether in the city alone or at the airport or both) and which is not likely to constitute a constraint on the ability of the first and second respondents to exercise a dominant influence in either or both places... Even regarding the airport as a separate market I should have thought that the first respondent would not be free from competitive restraint of the applicant's influence in the city area. The so called captive market at the airport could not, for example, be manipulated by the first respondent without it having some regard to its city competitors, its own reputation, and the goodwill of its own city business." (p 18)

Wylie J. specifically notes that duty free shops in town could be expected to provide constraints on the airport operation; an approach which contrasts with that adopted by Barker J. in the **Budget** case.

The issue of market definition was discussed by the High Court in the **Festival** case. It emphasised the importance of market definition to analysis of anti-competitive behaviour. The Court noted that the **QCMA** case was the leading authority on market definition. He also quoted from the **Edmonds Food** decision (Decision No 21) which has been adopted by the Commerce Commission in a number of cases.

The Court rejected the contention that one record album could constitute a market. It noted:

"We accept the evidence called for the Plaintiffs that when an album is charting well a sizeable percentage of popular album purchasers will want that product and will not be prepared to substitute it for some other. But in view of the short average time that such an album remains popular we see the albums which displace it in the chart ratings as clear substitutes. And it is clear from the evidence that at any one time when an album is enjoying popularity, promotion of another is gathering momentum. In our view the places at the top of the charts are a constant battle ground in which rivalrous conduct abounds." (p 17)

It added that:

"in reality no distributor or retailer could run a business on the basis of a market confined to one unique album. None of them do and as a matter of commercial commonsense none of them could." (p 17)

4.1.2 *Bare Transfer of Monopoly Power*

Wylie J. discussed the issue of bare transfer of monopoly power in the **Compass** decision. He noted the following:

"If A, who already has a dominant position, sells his business (and thus that position) to B, even though B does not have any other position or interest in the market, it is not easy to regard the transaction as resulting in other than the acquisition by B of a dominant position - and thus preventing the Commission from acting under Section 66(3)(a)." (p 22)

4.2 Exclusionary Provision

In the Budget case, Barker J. considered whether two competitors in the rental car market, Hertz and Avis, were giving effect to an "exclusionary provision" contained in an "arrangement" or "agreement" between them. On whether an arrangement was different from an understanding, Barker J. quoted from Taperell and Vermeesch:

"Arrangements and understandings are not terms of art, they were clearly included to catch the sort of collusion which does not give rise to a contract, such as a gentleman's agreement or a 'wink and a nod'." (p 32)

Barker J. also noted that a "good discussion" of the meaning of such words as arrangement and understanding could be found in the submission of the Australian Trade Practices Commission to the New South Wales Price Commission:

"An arrangement or understanding comes into existence as a result of some communication between the parties; the communication can however occur by written or spoken word the one to the other or by one observing and interpreting the other's behaviour. It is sufficient if the result of the communication is an expectation or hope in each party that the other is likely to act or not act in a particular way or for a particular purpose. There is no difference between an arrangement or an understanding in terms of anti-competitive purpose or effect. Any differences are a matter of degree - for instance, an understanding is likely to be more informal, the communication more subtle, the means of achieving the anti-competitive purpose or effect more vague or even open to independent unilateral action etc. The Courts have recognised subtlety and disguise as inevitable hallmarks of illegal collusion." (p 34)

Barker J. noted that "arrangements are rarely proved by direct evidence". Barker J. considered whether the the arrangements that each of Hertz and Avis had with the ARA constituted an "arrangement" or "agreement" for the purposes of section 29. He concluded that there was no extant understanding between Avis and Hertz; i.e. the agreements were between

Avis and the ARA and Hertz and the ARA and that there were "two lots of two way arrangements".

4.3 Substantially Lessening Competition

In the **Festival** case, the Court discussed the interpretation of "substantially". It quoted from Smithers J in the **Dandy Power** case:

> "I prefer not to substitute other adverbs for 'substantially'. 'Substantially' is a word the meaning of which in the circumstances in which it is applied must, to some extent, be of uncertain incidence and a matter of judgement. There is no precise scale by which to measure what is substantial. I think... the word is used in a sense importing a greater rather than a less degree of lessening. Accordingly in my opinion competition in a market is substantially lessened if the extent of competition in the market which has been lost, is seen by those competent to judge to be a substantial lessening of competition." (p 25)

The Court also noted the following statement made by Fitzgerald J. in the **Outboard Marine** case:

> "the answer in this case really depends on little more than one's own instinctive impressions formed by weighing the various considerations in this particular market which favour one view or another." (p 26)

Barker J. discussed the meaning of competition defined in s.3(1) of the Act to mean "workable or effective competition". He commented that the test of competition was not concerned with individual players in the market "but with the level of rivalrous behaviour in the market" (p 56). Barker J. quoted from **Donald and Heydon** in discussing the meaning of "workable or effective" competition:

> "We suggest that workable competition means a market framework in which the presence of other participants (or the existence of potential new entrants) is sufficient to ensure that each participant is constrained to act efficiently... To that end there must be an opportunity for each participant or new entrant to achieve an equal footing with the efficient participants in the market by having equivalent access to the means of entry, sources of supply, outlets for product, information, expertise and finance... Workable competition exists when there is an opportunity for sufficient influences to exist in any market, which must be taken into account by each participant and which constrain its behaviour." (p 57)

He claimed that that an application of the criteria of commercial commonsense indicated that rental companies with booths at the airport have a significant advantage over those that do not (**Budget**, p 60). He states at a later stage:

> "In economists' words, the present initial barrier to entry is very high which goes far to implying lack of competition in the market." (p 67)

He goes on to note:

> "I agree ... that it is commercial common sense to hold that, for the substantial business traveller segment of the market, there is no acceptable substitute to the collection of the car at the airport, with a minimum of delay and inconvenience... Restricted access to the airport market must result in a lower overall level of demand for Budget's services over the whole New Zealand market... As a matter of 'fact and of commercial common sense', I consider there is no acceptable substitute for the convenience of collecting a car and making the necessary arrangements at the terminal." (pp 60, 63 and 65)

He concluded that the contracts between the ARA and the rental car firms had both the effect and purpose of substantially lessening competition:

> "Although A.R.A.'s stated purpose was to maximise revenue, a 'substantial' purpose of the collateral contracts was to lessen competition... This purpose was to deny a potential third entrant the ability to compete on equal terms for the business of both tourists and business people." (p 72)

In the **Festival** case, the Court discussed whether the maximum retail price requirement imposed by Festival records on retailers would substantially lessen competition:

> "In our judgement... the stipulation [maximum retail price] impacts on such a small section of the market and in such a limited way, if at all, that it cannot be said that there is any substantial lessening, hindering or preventing of competition." (p 27)

4.4 Relationship Between Dominance and Substantially Lessening Competition

Although the **Budget** case was concerned with both "substantial lessening of competition" (S.27) and dominant market position (S.36) the judgment did not address the different tests applicable to the concepts of substantially lessening competition and market dominance.

Davison C.J. in the **Lion/Commission** case supported the Commission's interpretation of the relationship between substantially lessening competition and dominance:

> "What the Commission... [said] was that the 'dominance' test as provided for set a higher standard in respect of competition than a mere lessening of competition and that as the statute specifically requires the dominance test to be applied, lessening of competition need not be separately taken into account. No doubt, however, any lessening of competition is a factor to be weighed when deciding the issue of dominance in the market." (p 8)

4.5 Essential Facilities Doctrine

Barker J. concluded that the ARA was in a dominant position in the market given the definition of the market he had adopted. Barker J. introduces the concept of the bottleneck facility, a facility that cannot be readily replicated or circumvented. Barker adopted the following statement from a United States case (**Hech v Pro Football League**) on the essential facilities doctrine:

> "Where facilities cannot practicably be duplicated by would-be competitors those in possession of them must allow them to be shared on fair terms. It is illegal restraint of trade to foreclose the scarce facility. To be essential, a facility need not be indispensable; it is sufficient if duplication of the facility would be economically infeasible and if denial of its use inflicts a severe handicap of potential market entrants." (p 79)

He went on to note:

> "I consider that Mr Gault is correct to submit that a gateway facility is likely to beget a separate and identifiable geographic market and that exclusion from that market by means of the gateway, *prima facie* indicates anti-competitive intention unless the exclusion can be explained by reference to reasonable constraints in the circumstances"; (p 79)

and:

> "The exclusion of others by means of the bottleneck facility is anti-competitive; it should be eliminated by providing for the admission of others to the joint venture if they meet reasonable objective criteria." (p 77)

4.6 Procedure

The High Court has also noted the different treatment of mergers and takeovers in terms of procedure. In the **Compass** case, Wylie J. noted that in the case of restrictive trade practices "interested parties are entitled to participate in various procedures; enforcement proceedings by way of injunction can be sought by the Commission or any other person; and a right of appeal is given to interested persons" (pp 9-10). In contrast, "in relation to merger or takeover proposals there is no requirement for notice to the public or to persons who might think they are 'interested'". In addition Wylie J. stated "It is also significant, I think, that s.82 creates a civil liability in damages for any breach of the restrictive trade practices provisions but no such liability is created in the case of the merger or takeover provisions" (p 10).

Section 5 Assessment of the Act In Terms of Economic Principles

In this section the explicit statements of principle and the application of those principles adopted by the Commerce Commission and the High Court which were outlined in Section 3 and 4 are assessed against the principles outlined in Chapter One.

5.1 Objectives of the Commerce Act

Chapter One noted that people would attempt to maximise their welfare subject to the constraints facing them. They will undertake transactions to exchange (rights to) resources where such actions are mutually beneficial. The key policy question concerns how to set the constraints facing individuals so that their transactions with one another allow the maximum mutual benefit to be derived from scarce resources. The earlier chapter noted that in some circumstances the government could change the property right constraints within which transactions take place, so that further welfare-enhancing transactions could be made. Further transactions will occur if the sum of transaction and production costs are reduced by government intervention. Viewed in another way, antitrust laws will improve welfare if they improve the sum of productive and allocative efficiency compared with the situation in which antitrust intervention does not take place.

The key economic objective of maximising efficiency or minimising the sum of production and transaction costs is not recognised explicitly by the Commerce Act, nor has the Commission or High Court consistently adopted efficiency as an objective in its interpretation of the Act.

From an economic perspective there are two major weaknesses in the interpretation of the objectives of the Act by the Commission and the High Court.[8] First, both bodies have generally failed to recognise that *competition is valued as a process for promoting efficient resource utilisation, not as an objective in its own right*. Their approach tends to direct attention to the degree of overtly rivalrous behaviour when assessing lessening of competition and the acquisition and strengthening of a dominant position, rather than to the impact of different practices on allocative efficiency. The High Court in its statements of principle has explicitly emphasised the importance of rivalrous behaviour. The focus on competition per se also obscures the potentially valuable function of the Act's authorisation provisions as a mechanism for balancing productive efficiencies against losses in allocative efficiency.

The notable exceptions to this are the statements from the **Goodman/Fielder Wattie** and **Co-operative Dairy** cases quoted in Section 3.1. The approach adopted in **Co-operative Dairy** represents a departure from the previously stated principles and practices stated by the Commission in previous decisions. In that case, the Commission explicitly discusses competition in terms of its promotion of allocative efficiency.

Secondly, the Commission's very wide interpretation of public benefit significantly increases the risk that the Act will be used to pursue a myriad of different objectives, the great majority of which would be achieved at lower cost through more direct instruments of government policy. A wide-ranging public benefit test will also tend to create conflicts, in applying the Act, with the objective of economic efficiency and ultimately compromise the potential efficiency gains deriving from the Act.

5.2 Dominant Position

The two-step procedure embodied in the Act for evaluating takeover and merger applications could be reinterpreted as coping with both allocative and productive efficiency considerations: the dominance provisions of the Act lend themselves to the assessment of the

8 This is not to say that the Commission or the High Court's approaches are based on an incorrect application of legal principles of interpretation.

implications of a proposal for allocative efficiency while the public benefit test provides scope for the Commission to account for any countervailing productive efficiencies.

The Commission has identified market dominance as a test of market power. This is consistent with the approach suggested in Chapter One: the existence of market power indicates situations in which potentially beneficial transactions are not being undertaken.

The High Court has defined dominance in terms of the ability of a firm to "act independently" and in some cases implicitly adopted the test of market power. It appears, in general, to have ignored the approach taken by the Commission in studying similar issues. The statement on dominance in the **Continental Can** case referred to in both the **Budget** and **Festival** cases emphasised the importance of market structure in terms of assessing dominance. Davison C.J. in the **Festival** case explicitly linked market power to structural aspects of the market such as share of the market (p 15). These principles are not consistent with the approach in Chapter One; for example, the potential for new entry will constrain an incumbent's market power.

The Commission's approach to market power is a valuable first step and is more developed in economic terms than the approach adopted by the High Court. However, the key antitrust objective of economic efficiency has usually not been recognised by the Commission or the High Court. As a result the market power formulations expressed in **News/INL** and **Magnum/DB** do not provide a rigorous basis (in terms of the efficiency objective) for assessing dominance. As discussed in Chapter One, virtually all firms have some discretion over their prices and output levels yet still face external market constraints. Because neither the Commission nor the High Court has outlined the policy objective(s) underlying the dominance test, it is impossible using their formulation to determine why or when firms have too much discretion and are subject to too little restraint.

Similarly, the list of factors given by the Commission in **News/INL** does not provide a rigorous basis for assessing dominance. What weight should be given to each of the factors listed in **News/INL** and how should the information involved be synthesised in particular cases? The dominance principles adopted leave these questions unanswered.

The failure to specify sound economic objectives for the dominance test increases the risk that the application of the test will be based on administrative rules and legal precedent rather than a rigorous economic framework. Although the dominance principles adopted by the Commission are broadly consistent with the economic efficiency objective they provide significant scope for interpretations and applications that result in efficiency-reducing outcomes.

5.2.1 *Vertical Integration*

The principles for analysing vertical integration adopted by the Commission are based on the US Justice Department's 1984 Merger Guidelines and are in line with mainstream thinking on the competition implications of vertical integration.

5.2.2 *Bare Transfer of Monopoly Power*

The Commission correctly recognises that to decline mergers and takeovers merely because they involve a transfer of monopoly power from one entity to another would introduce an unwarranted restriction to the market for corporate control. Such a restriction would reduce the threat to under-performing corporate management teams and would reduce the overall efficiency of the corporate sector. Restrictions on the bare transfer of monopoly power would also reduce the flexibility for organisational and asset restructuring in response to changing economic circumstances.

The High Court's statement in **Compass** that it would be difficult not to view a bare transfer of monopoly as an acquisition of a dominant position is therefore of concern.

5.2.3 *Essential Facilities Doctrine*

The "essential facilities doctrine" introduced in the **Budget** case fails to discuss the implications of allowing access on a "fair" basis to privately-owned resources. It provides little guidance in assessing when market power would be such a problem that the right to exclude others from access to a resource should be attenuated. The approach adopted does not allow for consideration of trade-offs in terms of reduced incentives to invest or maintain such resources.

5.3 Constructs for Assessing Market Power

The greatest weakness in the Commission and High Court analyses of market definition, market concentration and barriers to entry is the failure to adequately relate these constructs to the task of assessing market power or to show the appropriate relationship between the constructs in conducting such an assessment. In a number of cases they have given inadequate recognition to the fact that market definition, market concentration and barriers to entry are the analytical tools for assessing the overall constraints on incumbent firms. As a result the principles laid down concerning these constructs have tended to be ad hoc and developed in relative isolation from each other. They have not specified what types and degrees of market response they consider should be evaluated at the market definition/market concentration stage and those which should be incorporated in the analysis of entry barriers. For example, should imports which would enter the New Zealand market in response to a small domestic price increase be included in "the market" (as the US Merger Guidelines propose) or captured in the analysis of entry barriers? Where should the impact of the effective excess capacity of competitors be taken into account?

Because of their failure to develop a unified treatment of market definition, market concentration and entry barriers the Commission and the High Court have frequently been inconsistent in the weight they have attached to different market responses and, on occasions, have ignored important constraints.

5.3.1 *Market Definition*

Market definition is important in practice because it assists in organising information relevant to an assessment of the constraints on the exercise of market power. The Commission's and the High Court's definition of a market "as a field of actual or potential transactions between buyers and sellers amongst whom there can be substitution... given a sufficient price incentive" (**Edmonds/Tucker**) is, in very general terms, consistent with the market definition principles. However, the definition of market adopted in the **Edmonds/Tucker** case is vague and not explicitly phrased in terms of evaluating constraints on market power. Again, this heightens the risk of analysis that is directed by administrative rules and ad hoc theorising rather than underlying economic objectives. In contrast the market definition framework contained in the US Merger Guidelines is well-founded, tight and forces practitioners to relate the exercise of defining markets back directly to the constraints facing incumbent firms. The introduction of the concept of sub-markets in the **Budget** case adds nothing to the analysis of the constraints on the exercise of market power and instead tends to confuse matters. In that case it appears to have resulted in the Court ignoring real constraints imposed by firms operating outside of the "sub-market".

The reference to "commercial common sense" is a further weakness in both the High Court's and Commission's market definition principles. Business people's perception of the markets in which they operate is heavily coloured by the most immediate and direct competitive pressures to which they are subject. As a result "commercial common sense" frequently neglects many of the demand and supply responses that would arise from a small but non-transitory increase in price above prevailing levels. For example, particle board manufacturers tend to perceive themselves as part of the particle board market, or alternatively, a section of the panel products market. However, flooring is the most

important end use for particle board in New Zealand and approximately half of new flooring is concrete. In the FCL/NZFP merger the Commission (correctly) accepted that particle board and concrete were part of the wider flooring market. To some extent, this approach conflicted with the "commercial common sense" of the participants in that market.[8]

5.3.2 *Market Concentration*

The Commission's discussion of market concentration correctly notes that there is no simple correlation between market concentration and collusive behaviour and that, in assessing dominance, market shares should not be viewed in isolation from other market information. Because of the considerable complexity of the relationship between market concentration and the likelihood of market dominance it would be inappropriate for the Commission to utilise rigid market share/concentration guidelines, except perhaps as a coarse filter to quickly approve obviously harmless transactions. The High Court on the other hand appears, at least implicitly, to accept that a high concentration equates to a large extent with dominance.

Nevertheless, both the High Court's and the Commission's framework for assessing dominance (and probably the quality of their decisions) would be improved by the adoption of a set of principles outlining the general reasons for, and ways in which, market concentration affects the likelihood and extent of market power. This would facilitate the development of a richer analytical framework and ensure that any consideration of market concentration measures was based on sound economic principles. For example, in evaluating the relationship between the magnitude of the likely response of competitors to a price rise by a particular firm and the market share of that firm, a richer framework would direct attention to the capacity constraints of existing firms and their potential for expanding output and capacity in response to higher prices. It would also highlight the interrelations between market concentration and entry barriers in the context of assessing the constraints on market power.

5.3.3 *Barriers to Entry and Potential Competition*

The Commission and the High Court have made very few explicit statements of principle concerning entry barriers and potential competition. The most significant general statement made by the Commission is that potential competitors will constrain incumbent firms when de novo entry is relatively easy. The High Court noted that a high barrier to entry implied a lack of competition in the market. The Commission and the Court have not set out any general principles for determining what types of market constraints are relevant in assessing entry barriers. In particular, their explicit statements of principle do not relate entry barrier analysis to the assessment of demand and supply substitutability.

The Commission and the High Court have generally also failed to recognise that many "entry barriers" protect the exclusivity of property rights in various resources and investments and thereby fulfil a valuable economic function. This failure heightens the risk of unwarranted interventions designed to lower entry barriers. For example, the exclusivity of property rights to key assets could be undermined as a condition of approving a takeover or merger proposal.

5.4 Substantially Lessening Competition

The Court's assessment of competition has emphasised the importance of rivalrous behaviour and the necessity for competitors to be on an "equal footing". Such an approach fails to recognise that economic efficiency is the underlying concern of policy and that competition *per se* is not.

---

8 See Parry, (1988), pp 6-7 for another critique of the "commercial common sense" approach to market definition.

The Commission has argued that in determining whether a practice has the effect of substantially lessening competition, regard must be had "to all of the surrounding market circumstances (including the role of substitutes, potential competition etc) in making a judgement as to the degree of market power created by the practice" (**Whakatu**, para 24, (ii)). This approach is consistent with an underlying concern with resource allocation and, in broad terms, in line with the interpretation of dominance adopted by the Commission.

However the Commission has also interpreted "substantially lessening competition", as involving a lower competition threshold than that applying to market dominance. The High Court in the **Lion/Commission** case supported the Commission's approach of assuming that dominance was a higher standard in respect of competition than a mere lessening of competition. In **Whakatu** the Commission argued that this approach "appears to have been consciously made by the legislature" and noted that the "Commission considers it proper to draw attention to Parliament's adoption of what appears to be a relatively low competition threshold ..." (Decision No 204, para 24 (iii)).

Regardless of the reasons for the interpretation by the Commission and the High Court, there is no obvious economic rationale for distinguishing between takeovers and mergers and other contractual arrangements in establishing jurisdiction and enforcement criteria for competition rules. Concern with efficiency should be the objective underlying the competition rules applying to both mergers and takeovers and "restrictive" trade practices.

A lower enforcement and jurisdiction threshold for trade practices runs the risk of distorting decisions regarding business organisation and encouraging the aggregation of business units in place of non-standard contractual arrangements between separate entities. Klein, Crawford and Alchian note that:

> "[m]any long-term contractual relationships (such as franchising) blur the line between the market and the firm. It may be more useful to merely examine the economic rationale for different types of particular contractual relationships in particular situations, and consider the firm as a particular kind or set of interrelated contracts. Firms are therefore, by definition, formed and revised in markets and the conventional sharp distinction between markets and firms may have little general analytical importance. The pertinent economic question we are faced with is; what kinds of contracts are used for what kinds of activities, and why?" (1978, p.326)

Franchising and many other "vertical" contractual devices are often used for similar reasons as vertical integration. The Commission's and High Court's interpretation of "substantially lessening competition" provides an incentive for firms using such vertical contracting arrangements to vertically integrate to reduce the risk of exceeding the competition threshold for the enforcement and jurisdiction of trade practices. Such a distortion could impose severe efficiency losses. The firms using vertical contractual arrangements have selected those methods of conducting business ahead of all other sets of contracts available to them. Vertical integration may involve diseconomies of scale for the organisations concerned[10] and impose major costs when measured against the initial contractual arrangements.

Their interpretation of "substantially lessening competition" also involves the risk that standard contractual arrangements (for example, "simple" sale and purchase agreements) will be substituted for more efficient but complex forms of business. A competition criterion that deters business practices involving insufficient market power to warrant intervention is

10 The transaction cost diseconomies of large organisations are analysed in detail by Williamson, (1984).

likely to raise business costs and discourage some practices that are desirable from a national benefit perspective.

Finally, it is inconsistent to have a lower competition threshold for jurisdiction and enforcement purposes than that applied for the purposes of balancing the detriment from particular trade practices against any countervailing benefit to the public (i.e. section 61(6)). This approach subjects trade practices to the authorisation provisions of the Act even though mergers and takeovers involving the same level of market power would not trigger the market dominance test.[11]

The approach set up in the Act and its interpretation by the High Court and the Commission is not logical in economic terms. This is particularly so given the Commission's view that in applying the authorisation provisions of the Act, the effect of both trade practices and mergers and takeovers should be judged in terms of their effect on market power (see **Whakatu** para 24 (vi)). While this inconsistency would be immaterial in a world of certainty and perfect and costless regulation, in reality it will deter, and possibly preclude, some efficient contractual arrangements. This is especially so given the practical difficulties in measuring benefits to the public, and the evidential requirements concerning public benefit imposed by the Commission.

A further weakness in the analysis by the Commission and the High Court of substantially lessening competition is the failure to outline a framework for assessing the degree of market power arising from particular practices. To an extent this is understandable because the issues to be analysed and appropriate method of analysis depend in part on the nature of the contractual arrangements being considered. Nevertheless, it would be feasible and desirable to establish broad guidelines for the analysis of particular classes of contracts, e.g. agreements such as that considered in **Whakatu** for the reduction of productive capacity. The questions given in paragraph 25(iv) of **Whakatu** are far too loosely specified to be of assistance in conducting rigorous analysis. The questions posed by the Commission increase the risk that the analysis of trade practices will be based on narrow legal formulations rather than a rigorous framework that accurately reflects the underlying policy concerns.

5.5 Public Benefit

5.5.1 *Nature of Public Benefit*

The public benefit provisions of the Act lend themselves to the assessment of productive efficiencies, to be weighted against losses in allocative efficiency arising from enhanced market power. However, as noted in Section 3.1 above, the Commission has argued that "there appears to be no limitation as to the nature of public benefit which may be claimed" (Decision No 205, para 25(i)). This interpretation opens the way for the entire spectrum of public policy and interest group objectives to be pursued through the public benefit provisions of the Act. As discussed in Chapter One, antitrust law should be directed by the objective of economic efficiency. Other objectives are generally met more effectively and at lower cost through more closely targeted instruments of government policy. The very broad

---

11 For example, in **Whakatu** the Commission found the degree of lessening of competition was "real or of substance" and therefore concluded that the "agreement concerned was one to which s.27 applies" (para 54). This conclusion was made even though the Commission recognised that the:

> "agreement which is the subject of this case does not prevent or inhibit future competition between the applicants and there is no evidence that the opportunity for competition to occur in the defined market does not exist ... No-one suggested that any one of the remaining operators would have a sufficient degree of market power (or even a substantial increase in market power) to control price or output." (Decision No 205, para 58)

interpretation of public benefit adopted by the Commission is likely to complicate the administration of the Act and compromise the objective of economic efficiency.

5.5.2 *Weighting to Alternative Public Benefits*

The Commission's express statements of principle concerning public benefit indicate that the Commission considers the public benefit provisions of the Act to be an appropriate means of pursuing distributional objectives.[12] The notable exception to this is the **Co-operative Dairy** case in which the Commission explicitly rejected a distributional objective for antitrust policy.

The Commission has provided no analysis to demonstrate that differential weighting is an effective means of pursuing any valid policy objectives. Antitrust is poorly suited to the pursuit of distributional objectives. The approach taken by the Commission also runs the risk of compromising the efficiency objective. In several cases, the Commission has given minimal weight to potentially very large efficiency gains because of the identity of the recipients of those gains. On the basis of this aspect alone, there is a reasonable probability that the Commission has declined mergers that would have enhanced economic efficiency.

This issue has recently been emphasised by Australian economists commenting on the public benefit test. Officer makes the following comments:

> "It would be, in my opinion, redundant to have a Part IV [of the Australian Trade Practices Act] concerning itself with consumer protection on the assumption that somehow consumers are at a disadvantage in their contractual relations with producers and to give greater weight on **per se** grounds to consumers relative to producers in any summation of individual benefits to reach society's total benefit. There is no theory or evidence to suggest that consumers as a class are necessarily different from producers or poorer, to the extent that a dollar distributed to consumers away from producers is going to raise society's total utility (benefit)...
>
> In short, it is a mistake to believe that as a general principle allocating resources or dollars away from companies to consumers increases the net welfare of society. The reverse also would be without foundation. Moreover, as I have been at pains to point out, Part IV of the Trade Practices Act is aimed at resource allocation amongst the productive units and not at a redistribution of wealth. In these circumstances, the public, in the context of section 90 of the Act, should mean everyone in society and no one member or group should be given greater weight in any assessment of benefits or detriments to any other individual or group within the society. Under this proposition a dollar is worth the same to the company as a dollar to its clients (consumers)" (1987, pp 7-8).

Similarly, Williams argues that:

> "[i]t is clear that despite the urgings of economists, the Australian Trade Practices Commission, and New Zealand's Commerce Commission do not always adopt the standard of economic efficiency in their evaluation of public benefit. In particular, they frequently depart from Hume's law that a dollar is a dollar. Because they value benefits to consumers above benefits to, say, shareholders, both bodies have hesitated to classify cost reductions from restructuring as public benefits unless competition in product markets compels the restructuring firm to pass on these benefits to purchasers in the form of lower prices."

12 See especially **Whakatu** (para 25(iv)), **Amcor/NZFP** (para 53(v)) and **FCL/NZFP** (paras 167-169).

He adds that:

> "[t]o deny Hume's law is to confuse the efficient allocation of resources with the distribution of income. The authorities which administer trade practices statutes should not have to pursue two goals simultaneously." (1988, p 11 and p 12)

5.5.3 *Standard of Proof for Public Benefits*

The Commission has stated that it will not accept "mere...assertions and vague claims" (Decision No 201, para 263) as public benefits. Instead, claims should be "reasoned and specific" and there "should be evidence to show that the alleged beneficial effects (specific or otherwise) are likely to happen" (Decision No 208, para 53(ii)). The Commission has also argued that "[a]t the end of the day...it is the responsibility of the applicant to satisfy the Commission that it should grant the privilege of authorisation" (Decision No 205, para 25).

The requirement that public benefit claims are backed by very good evidence is important for two reasons. First, as Williamson argues, "the data [on efficiencies] is distributed unevenly to the strategic advantage of the defendant" (1977, p 703). Further, as White suggests:

> "[e]fficiencies are easy to promise, yet may be difficult to deliver. All merger proposals will promise theoretical savings in overhead expense, inventory costs, and so on; they will tout 'synergies'" (1987, p 18).

For this reason, Fisher argues that:

> "[t]he burden of proof as to cost savings or other offsetting efficiencies... should rest squarely on the proponents of a merger and here I would require a very high standard. Such claims are easily made and, I think, often too easily believed." (1987, p 36)

It is essential though that the standard of proof for efficiencies be examined in the light of the evidential requirements relating to market power (i.e. dominance and substantially lessening competition). In particular, the tests of market power and the test for public benefit need to be struck so as to minimise the total cost of precluding or deterring efficient business practices and the cost of letting some efficiency-reducing practices slip through the antitrust net. While efficiencies are often hard to demonstrate, there is considerable theoretical and empirical evidence covering the efficiencies resulting from takeovers and mergers and increasing evidence regarding the efficiency advantages of various trade practices. A high standard of proof for public benefit therefore implies that a high standard of proof is desirable for determining whether there is an efficiency-reducing quantum of market power.[13]

This argument has not been recognised by the Commission which has based its evidential onus for dominance/substantially lessening competition and public benefit on a strict legal interpretation of the Act. Unless the standard of proof for dominance and substantially lessening competition, applied by the Commission is sufficiently high to reflect the high

---

13 The implications of this perspective for horizontal merger policy in the United States (where there is no 'public benefit' or equivalent test) are summarised by Schmalensee as follows:

> "Since I hold the consensus view that most horizontal mergers have only a tiny probability of raising prices and that many have positive efficiencies, and since I doubt (perhaps naively) that this consensus is likely to be radically revised in the foreseeable future, I think the law should require more of those who oppose mergers.
>
> I am thus comfortable with the core language in the [Reagan] administration's proposal which would require that there be a 'significant probability that the merger will substantially increase the ability to exercise market power.'" (1987, p 45).

standard of proof for public benefit, the standards of proof adopted will tend to bias the Commission's analysis towards the rejection of too many mergers and trade practices.

5.6 Measuring Competitive Detriment and Lessening in Competition

The Commission's discussion of lessening of competition in **Whakatu** implies that the Commission intends to apply a market power criterion in applying both the "lessening of competition" and "competitive detriment" tests. This is consistent with an underlying concern with economic efficiency. However, it is only in the recent **Co-operative Dairy** case that the Commission has expressly adopted allocative efficiency as the criterion underlying "competitive detriment" and "lessening of competition".

The quality of the Commission's principles on competitive detriment and lessening of competition are greatly undermined by its statement that "there appears no limitation as to the nature of...the competitive detriment flowing from the lessening of competition" (Decision No 205, para 25(i)). As with the Commission's express statements on public benefit, such an approach increases the risk that the Act will be used to pursue numerous different policy objectives, the great majority of which are not able to be pursued in a cost-effective manner through competition rules.

Similarly, various trade practices that protect investments in quality and good reputation could be deemed to contravene Section 27 of the Act merely because they raise entry barriers.

Section 6 Conclusion

Both the Commission's and the High Court's decisions are framed in terms of their legal interpretation of the Act and the precedents relating to it. The following comments do not therefore necessarily imply criticism of the Commission or the High Court.

Although parts of the Commission's and the High Court's analyses have been of a high standard, a number of fundamental principles adopted and applied diverge in important ways from widely accepted economic thought. The major weaknesses in the decisions, from an economic perspective, may be traced back to the failure to specify an efficiency objective in the Act, and on failure by the Commission or the High Court to adopt or apply economic efficiency as its underlying objective. Insufficient recognition has been given to the fact that competition is valued as a means of promoting efficient resource utilisation rather than as an end in itself. The objectives pursued under the Act have been further confused by the Commission's wide-ranging interpretation of public benefit.

The Commission's focus on market power in its application of the "dominant position" and "substantially lessening competition" tests is commendable whereas the failure of the High Court to draw on the Commission's work or to develop a consistent economic framework is of concern. Both the Commission and the High Court have failed to develop an integrated and consistent framework for evaluating market power. In particular, they have inadequately specified the role of the key antitrust constructs of market definition, market concentration and entry barriers, and the relationship between these constructs, in assessing market power. The High Court has relied extensively on market share in assessing market power, ignoring factors which could constrain firms. The lists of factors the Commission has provided to assist in the application of the "dominant position" and "substantially lessening competition" tests are loosely specified and heighten the risk that legal rules rather than underlying policy objectives will shape the analysis of those tests.

The failure to outline a comprehensive and rigorous framework for assesssing dominance is perhaps one of the reasons for the low quality of the applied analysis in several of the major merger cases heard by the Commission under the Commerce Act as well as the High Court cases. The Commission's unsatisfactory treatment of excess capacity and predatory pricing, for example, follows from the fact that the Commission has not developed an explicit framework to address those issues. Unfortunately, in some areas where the Commission has adopted sound principles (e.g. vertical integration) its application of those principles has sometimes been unsatisfactory. The High Court's adoption of the essential facilities doctrine without any detailed economic analysis is of concern.

The interpretation of "substantially lessening competition" as involving a lower competition threshold than "dominant position" is a particularly serious flaw in decisions under the Act. This reflects a concern with the form of competition adopted rather than the efficiency of the competitive process. This is likely to distort decisions regarding business organisation and increase the costs facing those firms/industries that are forced or encouraged to adopt sub-optimal forms of organisation.

The greater weight placed by the Commission on public benefits that accrue to consumers as opposed to shareholders, employees or other parties, also conflicts with the goal of economic efficiency. The Commerce Act will generally be an imprecise and expensive means of pursuing objectives other than efficiency. The Act is unlikely to have any systematic impact on distributional outcomes. On the other hand, as the Commission's decisions illustrate, the pursuit of distributional objectives will compromise the objective of economic efficiency.

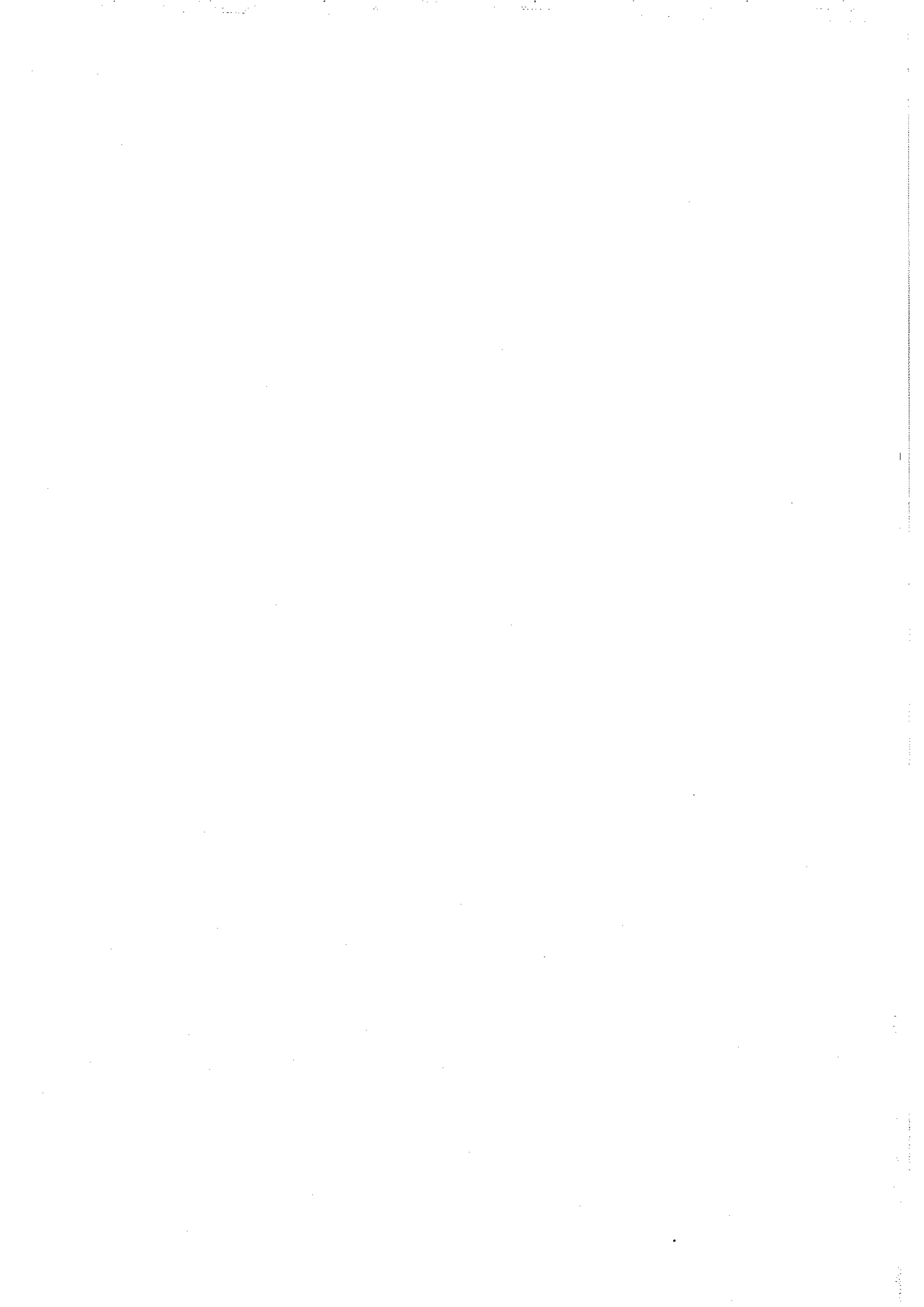
The high standard of proof adopted by the Commission in its assessment of public benefit claims is, in itself, desirable. Public benefit claims are easily made but less likely to be delivered. However, the standard of proof for public benefit should be set in conjunction with that for the Act's tests of market power, i.e. "dominant position", and "substantially lessening competition". This is necessary to balance the costs of preventing some efficiency-

enhancing practices and the costs of allowing some efficiency-reducing practices to slip through the antitrust net. This perspective is not reflected in the standard of proof applied by the Commission in determining dominance and substantially lessening competition. On balance, the standards of proof adopted by the Commission are likely to result in too many efficient arrangements being deterred or precluded.

The Commission and the High Court have failed to rigorously specify the nature of the detriments resulting from market power to be considered in balancing such detriments against countervailing public benefits. Both the Commission's and the High Court's analyses of this issue demonstrate, though, that their conception of detriment extends far beyond concern with allocative efficiency. In particular, the Commission has exhibited concern with the size of the income transfers in particular markets arising from the strengthening of market power. Given the inappropriateness of pursuing distributional objectives through competition law, this perspective greatly overstates the "detriment" resulting from the strengthening of market power.

There have been too few decisions by the High Court to assess the overall impact on efficiency. The weaknesses in some of the economic analysis, however, give cause for concern.

The major weaknesses in the Commission's analysis give rise to a bias towards intervention. The low threshold for substantially lessening of competition test, excessive concern with market structure, and unfocused analysis of the detriments resulting from market power, all tend to overstate the economic costs of mergers and takeovers and non-standard contractual arrangements. The reduced weight given to public benefits that accrue to groups other than direct consumers tends to understate the economic benefit resulting from particular practices. These effects are aggravated by the high standard of proof applied by the Commission in assessing public benefits relative to that applied in assessing market power. The approach taken by the Commission is likely to prevent too many efficient business arrangements. We consider that the Commission's present interpretation and application of the Act is imposing significant efficiency costs when measured against superior but achievable competition rules and interventions.



CHAPTER FOUR : REFORM OF THE COMMERCE ACT

Section 1 Introduction

Policy-makers have long been concerned about the potential harm to efficiency that could arise from the exercise of "market power" by organisations. Recent economic analysis has reduced, but not eliminated, concern about the nature and scope of the monopoly problem particularly in markets that are open to competition. Well-designed antitrust policies could raise efficiency. However, the costs of particular antitrust laws may outweigh the benefits.

In New Zealand, many interventions under the Commerce Act 1986 may have impeded rather than enhanced New Zealand's economic performance. The problems stem both from the nature of the Act and its application.

The outcomes from antitrust actions in New Zealand could be improved by clarifying the objectives of the Act, streamlining procedural arrangements and adopting a system of filters that would help screen out cases where there are unlikely to be any market power problems.

1.1 The Case for Antitrust

The purpose of economic activity is to meet people's needs as consumers given limited resources. Market competition is acknowledged as the best way of coordinating that activity in many cases. The conjunction of self-interest and scarce resources makes it important to establish welfare-enhancing constraints within which economic activity takes place. The design of the overall regulatory regime (including the Commerce Act) involves choosing the constraints that will best achieve social objectives.

While market competition, within the general regulatory framework, has always been recognised as of fundamental importance in promoting efficiency and consumer welfare, the manner in which the regulatory framework should be viewed has shifted significantly. Greater emphasis is now being given to the dynamic, innovative and pervasive nature of competition and the importance of transaction costs in explaining efficient market arrangements. Leading economists no longer accept that the existence of competition can be identified by counting the number of organisations operating in the market. Rather, they acknowledge the importance of potential domestic or foreign competitors or alternative products in affecting the behaviour of incumbent firms.

Competition is valued for its potential contribution to economic efficiency and consumer welfare, not as an end in itself. Particular market structures and contractual arrangements should not be rejected because they do not measure up to some idealised concept of competition, but should be evaluated in terms of their contribution to efficiency and therefore consumer welfare.

Most firms are unique in some way. Their products differ in terms of their characteristics and quality, the convenience of service, or guarantees and after-sales servicing, and the firm's ability to inform customers about its products through advertising and brand names. Most firms therefore have some degree of market power. This arises as a natural result of a lack of product homogeneity and imperfect consumer information. Generally, the degree of such market power is too small to be of concern. In such cases, antitrust interventions are not likely to improve the efficiency of outcomes.

Market power exists along a continuum from differentiated sellers which give no cause for concern to monopoly situations. No general rule indicates precisely when market power becomes a problem.

An organisation which is relatively unconstrained by actual or potential alternative suppliers or alternative products may restrict output and misallocate resources relative to the outcome achievable through antitrust intervention. This may arise even if the market is open to new entrants. More often it is due to statutory protection.

In recent years, economic analysis (led by research in the United States) has resulted in less concern about the scope and nature of the monopoly problem and an increased awareness of the potential costs associated with antitrust intervention.

Antitrust analysis has moved away from a narrow focus on measures of concentration and entry barriers to a greater understanding of the potential efficiency benefits arising from mergers and complex contracting arrangements. The comparative institutional approach emphasises the importance of comparing alternative achievable arrangements in assessing whether a monopoly problem exists. The fact that reality does not conform to a theoretical economic model does not justify antitrust interventions. There needs to be a positive onus of proof that interventions will produce a superior outcome. The costs of reducing any losses associated with monopoly must be included in the assessment of whether or not antitrust interventions can improve outcomes.

Antitrust intervention will involve costs both in the administration of the system and in the way in which it will inevitably condemn practices which actually enhance efficiency. Badly designed antitrust laws could involve significant costs. Because of the costs associated with antitrust laws and the difficulty of determining whether or not a monopoly problem actually exists, we can never be certain that antitrust intervention will result in an overall improvement in welfare. In New Zealand, the serious weaknesses in the Commerce Act and in some of the economic analysis adopted and applied by the Commerce Commission and the Courts mean that the Act has, at least in some situations, and conceivably on balance, impeded rather than enhanced New Zealand's economic performance.

1.2 International Experience

International lessons in the analysis and practice of antitrust are somewhat mixed. Insights provided by economic research have had a strong impact on the practice of antitrust in the United States. Economic analysis is now part of the standard legal tool kit of lawyers, judges and law clerks. Recent Supreme Court decisions have drawn extensively on both theoretical and empirical economic analysis.

The focus of economic thinking on antitrust in the United States has shifted from concerns about structural measures of competition to greater recognition of the importance of the potential constraints imposed by new entry, fringe firms and foreign competition. Efficiency is now seen as an important objective of antitrust policy.

Earlier concerns about vertical mergers *per se* have been rejected and, consistent with economic theory, vertical mergers now only raise concerns where they have a horizontal impact. In the past decade, virtually no government enforcement actions in the United States have been directed at the vertical aspects of mergers. A similar economic approach to vertical contracting arrangements has developed in the United States with efficiency aspects of vertical restrictive trade practices being increasingly accepted by the courts.

Canada, like New Zealand, introduced new antitrust legislation in 1986, in the Canadian case replacing a criminal law system based on turn-of-the-century anti-combines legislation. In many respects this has brought Canadian practice close to practice in the United States, although treatment of price-fixing agreements remains relatively restrictive. Academic debate in Canada also appears to follow that in the United States relatively closely.

In contrast, very little "state of the art" economic analysis has emanated from the United Kingdom. Its antitrust policies do not appear to be based on any consistent economic framework, as evidenced by the conflicting decisions that have been made. Hanson and Mather observe that:

> "British competition policy has in recent years been under virtually continuous review because of the difficulties inherent in detemining issues of economic concentration and efficiency against vague criteria of the 'public interest'." (1988, p 82)

In the United Kingdom mergers are generally implicitly assumed to be beneficial and few mergers that fall within the jurisdiction of the Monopolies and Mergers Commission are actually reviewed. However, those that are reviewed appear to have little prospect of success. The Monopolies and Mergers Commission's analysis has moved from a concern about market share through to an emphasis on the adverse impact of mergers on the management of a target firm and back to concern about structural considerations. Consideration of entry conditions appears to be rare and any efficiency effects largely ignored. The general approach to restrictive trade practices appears to have been one of hostility.

Section 2 The Design of a New Act

2.1 Objective of Antitrust

The conclusion that follows from the economic analysis reviewed in this study is that antitrust laws should serve consumer welfare. In general, consumer welfare will be promoted when resources are allocated efficiently. Adopting "competition" as an objective of antitrust law risks compromising the efficiency objective. Instead competition (in the sense of maximum rivalry) may be pursued as an objective in itself. The result may be to prevent efficiency-enhancing arrangements which reduce the number of players in a market or lower transaction costs. Practices which enhance efficiency overall but which result in greater market power may be prevented or deterred.

An explicit recognition that the objective of the Act is to promote economic efficiency as a means to enhancing consumer welfare would improve the focus of the Act. It would help guide antitrust administrators when faced with an apparent trade-off between competition and efficiency.

We note that the Department of Trade and Industry's discussion paper accepts that the Commerce Act "is one of a number of government policy initiatives designed to promote efficiency". It suggests that "the Act's specific role is the promotion of competition in markets towards this end". It concludes, however, that "the promotion of competition is consistent with the enhancement of efficiency, and is a distinct objective which more accurately describes the Commerce Act's purpose".

The preceding discussion has shown that the promotion of competition, in the sense of encouraging maximum rivalry, is not always consistent with an objective of economic efficiency, nor is it a valid objective in its own right. We remain concerned that unless the underlying objective of efficiency is clarified, arrangements that do not conform with the administrators' concepts of "competition" may be prevented even when they enhance overall efficiency and consumer welfare. This possible conflict would be removed if the Act contained an explicit statement that the overall objective was economic efficiency. Alternatively the Act could state that the process of competition is valued to the extent that it promotes efficiency.

Income distribution issues should not be pursued through antitrust policies. While objectives other than efficiency and general consumer welfare are proper concerns of any government, these are generally met more effectively and at lower cost through other instruments of government policy. In general, trade practices and mergers have little systematic impact on the non-efficiency objectives most frequently proposed as goals for antitrust law.

In certain restricted circumstances, the government might be concerned about the income distribution effects of a particular business arrangement. We believe that those circumstances are sufficiently rare that they can be handled on a case by case basis as they arise and should not be incorporated into the antitrust laws (beyond the existing provision that gives the government the right to direct the Commission on matters of government policy).

2.2 Treatment of Different Practices

Approaches to market regulation have been fundamentally reassessed in New Zealand during the past 10 years. Wide-ranging reviews of efficiency policies have occurred since 1984. Such policies aim to maximise national income by encouraging greater efficiency in resource use. This objective is being pursued through a much greater reliance on market incentives constrained by an improved legal and regulatory framework within which individual and commercial decision making can take place. Income distribution objectives have been seen as most effectively pursued through welfare transfers.

The degree of detailed regulation of markets has been steadily reduced and domestic organisations are increasingly exposed to international competition. The Government has removed many statutory monopoly provisions that had the effect of protecting producers at the expense of consumers. State-owned enterprises are increasingly facing competition in their product markets. The Government's reforms have reduced the scope for firms to exploit protected monopoly positions.

However, some monopoly problems remain. For example, producer boards, professional bodies, some state-owned enterprises and labour organisations enjoy statutory protection from competition. The Government should continue to deal with the monopoly problems that arise using the best policy devices available. Where sound economic or social reasons do not exist for continued statutory protection, the best approach is to remove that protection. Even where a monopoly position is justified, its exploitation by organisations granted statutory protection is not acceptable and the sanctions of the Act should apply. Patents, like other property rights, should be regarded as properly scaled barriers to entry (assuming patent law is well designed) that do not generally raise antitrust concerns.

Antitrust policies must be reviewed in the overall context of the Government's economic reforms. The Act should be designed to play a complementary role to other changes the Government has made. It should apply to all arrangements, whether in product or factor markets, that will result in the restriction of output (or a reduction in quality) in a manner which reduces efficiency and thereby harms consumers.

Potential welfare losses in the labour market, which remains closely regulated, may be much more significant than those occurring in the more deregulated product markets. The Commerce Act should apply to labour market arrangements except where this conflicts with provisions of alternative legislation. In many jurisdictions, including New Zealand, antitrust laws have at various times covered labour market practices and the rules of professional bodies. The Act should not be concerned with combinations such as unions *per se*, or collective bargaining or other collective arrangements, as long as they are not used to reduce efficiency. It should be invoked when such arrangements result in the group exercising market power in a way that would result in the misallocation of resources at the ultimate expense of consumers.

Market economies involve an ongoing contest between alternative ways of organising economic activity. Organisational arrangements tend to develop which minimise the costs of carrying out economic activity including transaction and production costs. Contracting arrangements occur along a range from simple spot market transactions through complex contracting arrangements to organisation of activities within a firm. There is no sharp dichotomy between mergers and commercial practices and little reason for subjecting them to different regulatory rules.

Vertical mergers or vertical trade practices are of interest in terms of allocative efficiency only for their horizontal impact at one or other level of the market. The ability to restrict output and raise prices flows from the ability to control output at any one level of the production process; vertical mergers are of concern only when they increase this market power. For example, vertical contracting arrangements may facilitate collusion between rivals when barriers to entry are high and the market is concentrated. Unless such factors are present, vertical arrangements are unlikely to raise concerns.

The antitrust laws should not bias the choice of business arrangement adopted. As a result, it makes sense to ensure that all arrangements are treated in the same way by the law. We suggest therefore that there should be only one set of provisions in the Act which applies to all arrangements. That is, there should not be separate provisions that apply to commercial practices and to mergers and takeovers.

Because of the complexity of some business arrangements and the various ways in which they may improve efficiency, we do not support a case for *per se* prohibition of any practice. *Per se* prohibitions can be justified only where the gains in terms of savings in administration costs

and increased certainty outweigh any potential losses arising from the prohibition of efficiency-enhancing arrangements. We do not believe that any practices would readily pass this test. In any case, an arrangement clearly designed to restrict output and raise prices ought to be readily detected using a rule of reason approach and the set of filters that we propose.

We see no reason why the Commerce Act should have special provisions for different industries. Any concerns about foreign ownership or media control, for example, should be dealt with directly by the government under more appropriate statutes.

2.3 Filters

Because a rule of reason approach may be relatively costly, the adoption of clear rules which interpret the efficiency criteria will be necessary to indicate to firms what behaviour is unlikely to raise concerns. A series of filters can simplify the process of eliminating from consideration those arrangements that are unlikely to reduce efficiency. Their adoption would help businesses know where they stand and facilitate the work of the Commission as well as enabling better self-enforcement of the law. The use of filters means that most cases could be dispensed with relatively quickly. Valuable resources could then be devoted to analysing situations in which problems may potentially arise.

The filters should be chosen to permit any business arrangements unlikely to result in a significant amount of market power. This requires focusing on the constraints that would prevent a firm (or other organisation) from restricting output (or reducing quality) in a way that will give rise to inefficient resource use.

The filters should be applied to all business arrangements that could give rise to potential concerns. If an organisation passes any one of the filters, then no antitrust policy issue shall be deemed to have arisen. Failure to pass all of the filters would activate further analysis.

Our proposed filters may enable the current asset filters, which do not relate closely to the efficiency objective, to be dispensed with.

The tests could be quantified and incorporated into the statute. Alternatively, the principles outlined could be incorporated into the Act and the Commerce Commission or some other body could issue guidelines that specified the tests to apply. Possible numerical standards should be a matter for more detailed examination.

An appropriate definition of the relevant market is a prerequisite for applying the filters to calculate market shares, market concentration, and barriers to entry. The initial assessment of market definition, in combination with an assessment of imports, importables and exports, market concentration, and barriers to entry and to negotiated solutions, can quickly clear a large number of mergers that are unlikely to reduce efficiency.

The 1984 US Justice Department Merger Guidelines attempt to define the market "in which firms could effectively exercise market power if they were able to co-ordinate their actions" (US Merger Guidelines, p. S-1). The market is defined as a set of products and geographic area which would permit a hypothetical single firm, which owned all the existing production capacity, to raise its prices above current levels. The Department will in most cases use a price increase of five percent lasting for one year as its test. The Guidelines' treatment of market definition features a consistent analysis of the product and geographic aspects of the market:

> "Formally, a market is defined as a product or group of products and a geographic area in which it is sold such that a hypothetical, profit-maximizing firm, not subject to price regulation, that was the only present and future seller of those products in that area would impose a 'small but significant and nontransitory' increase in price above prevailing or likely future levels." (1984, S-1)

Taking existing prices as the standard of measurement allows the enforcement agents to avoid the possibly difficult task of assessing a level for competitive prices. It may, however, allow two colluding firms to merge to prevent the cartel from collapsing.

Fisher emphasises that the process of determining the market boundaries should be used as an aid to organising information and not pursued as an end in itself. To be useful, the market definition must include all those products and services produced by other firms that would constrain the behaviour of the firm under consideration. The constraints are vitally important; market definition itself is not independently helpful:

> "[M]arket definition, if it is to be an aid to analysis, has to place in the relevant market those products and services and firms whose presence and actions can serve as a constraint on the policies of the alleged monopolist... A market will thus be well defined if and only if the share measurements it leads to provide some reasonable index of the true power of the alleged firm. The discussion of entry really then supplements the share measure to show the ability of the firm to maintain share when earning supra normal profits.
>
> Thus, the primary question in defining a relevant market ought to be that of the constraints on the alleged monopolist. The principal constraints can be of two types, those relating to demand and those relating to supply... Demand substitutability refers to the ease with which consumers of the alleged monopolist's products can substitute the products of others. If this is relatively easy then an attempt by the alleged monopolist to raise prices and earn supra normal profits will lead consumers to switch away from him... The second kind of consideration in market definition is that of substitutability in supply." (1979, p 13)

Conceptually, however, it does not matter where the market boundary is drawn. As long as all relevant information is given appropriate weight, either during the analysis of market share/market competition or as part of entry conditions/potential competition, the overall assessment of welfare losses will not be affected by whether particular products are considered to be "in" or "out" of the market.

The market is defined in the Commerce Act as a "market for goods and services within New Zealand that may be distinguished as a matter of fact and commercial common sense". The discussion paper notes that criticisms have been leveled at this definition because "a market distinguished as a matter of fact and commercial common sense is somehow different from a market in an economic sense". It dismisses the second concern by noting that it "appears to be largely semantic". It is acknowledged that a business person's interpretation of a market may be narrower than that required for economic analysis but the defence is offered that the Commission and Courts have generally tended to adopt a broader economic approach. We believe it is not sufficient that these bodies should *generally* adopt that appropriate approach. If the reference to "commercial common sense" sometimes results in an inappropriate market definition, it should be deleted. Nothing is gained by the definition and the potential remains for mistaken definitions to be adopted. The filters that may be applied once the market has been defined are discussed below.

2.3.1 *Good Currently Imported*

If a good or service is currently being imported and sold in New Zealand (in amounts above some minimum threshold), a domestic firm will not have a significant amount of market power. We propose that the existence of foreign competition be used as the first filter. Even a single domestic producer will be constrained in any ability to exercise market power if the goods or services it is producing are currently being imported. The existence of a tariff on a product does not alter this situation, unless it is so high as to shut out all competitive imports.

The increasing openness of New Zealand to foreign competition will result in more firms being exposed to the international market. They will have little market power in such circumstances.

2.3.2 *Good or Service Potentially Imported or Currently Exported*

If a good that is not currently imported could be imported in response to a domestic price rise, then the domestic firm will not have a significant degree of market power.

The US Merger Guidelines refer to the ability of a firm to enter the market if the price was increased by five percent. We propose that a similar test to that be applied locally. For example, the viability of importing the good into New Zealand could be assessed by examining the price of the good in Australia (or another country) and estimating the transport and other costs (including costs associated with distribution) of importing it into New Zealand. If a five percent increase in the price charged by the New Zealand firm would make importing worthwhile, then it could be concluded that the New Zealand firm would be sufficiently constrained that no efficiency concerns would be raised.

Scheduled tariff reductions will also be relevant in assessing the potential import competition in response to any attempt to exercise increased market power.

Where a New Zealand supplier competes in international markets, it will be constrained in its domestic behaviour by the world price plus transport costs as long as its product can be reimported back into New Zealand. Applying a similar test to that for importables, we conclude that if the cost of transporting the good from another country to New Zealand were less than five percent of the world price of the good, the domestic firm would not have a significant degree of market power.

2.3.3 *Market Concentration*

Market concentration measures summarise some aspects of complex relationships and help indicate whether or not a firm or group of firms could exercise market power. We normally presume that the smaller a firm's market share, the smaller its market power because other suppliers will be more likely to quickly expand output and market share in response to a price rise. Similarly, explicit or tacit collusion becomes more difficult as the number of firms necessary to control a given percentage of output rises.

Unfortunately, market concentration only provides a rough indicator of those considerations. For example, the fact that a significant producer (say resulting from a merger) faces a number of competing firms means less if those firms face serious capacity constraints since they may not be able to expand output easily in response to higher prices. In other cases, new firms may be able to readily enter a market (for example, by switching output from another market, making better use of capacity or by modifying their product) thereby placing a tight constraint on the high market share of existing suppliers.

While a large market share does not prove significant market power, a low market share usually implies little market power. A certain minimal market share, or an estimate of the concentration of firms in the market, can therefore be used as a filter.

Because of the smallness of the New Zealand market, economies of scale or managerial economies may be realised at a level that results in relatively high market shares. Efficiency considerations would then support the case for higher levels of concentration than in large markets such as the United States. We propose therefore that the concentration standard be set at a significantly higher level than in the United States.

2.3.4 *Barriers to Entry*

An assessment of entry barriers is essential to determine market power and the constraints on an incumbent firm. It assists in organising information not accounted for in defining the market and in estimating market shares. For example, excess production capacity may not be recognised as a constraint in the market definition/market share exercise, but it must be considered in evaluating entry conditions.

The theoretical discussion in Chapter One established that entry barriers fulfil a vital economic function. Potential entrants to all markets face entry and exit hurdles of one type or another, many of which are important in facilitating efficient resource utilisation. There are always positive economic costs involved in entering an activity, and even large scale capital investments are not in themselves a barrier that should be of concern. Private property rights constitute barriers to entry. For example, the fact that one is not able to grow crops on someone else's land without first obtaining permission is a barrier to some activities. Ideally, barriers ensure that the costs of resources to market participants reflect the value of those resources to society. They also protect investors from free-riding by new entrants, thus providing market pioneers with an incentive to develop the market in the first place.

We concluded that some barriers to entry could so delay new entry into a market that an incumbent firm could raise prices and restrict output for a significant period of time. Worrying barriers to entry comprise:

* legislative barriers that unduly prevent customers from contracting with alternative suppliers; and
* sunk costs, particularly in combination with economies of scale, where these are a significant feature of the investment required for business.

If legislated barriers and sunk costs are modest, then entry or the threat of entry into the market in response to a price increase should constrain an existing firm's behaviour.

2.3.5 *Negotiated Solutions*

The supplier may be able to readily negotiate with its customers to achieve an increase in supply. Price discrimination may enable an increase in output and a reduction in the efficiency costs associated with market power. However, because the costs of achieving price discrimination can outweigh the benefits, further analysis may be required to clarify when welfare-enhancing negotiated solutions might be achieved.

2.4 Further Analysis

When a firm fails all five filters (Sections 2.3.1 - 2.3.5), more detailed analysis of the factors which constrain the firm, and the likely magnitude of any efficiency losses associated with the practice in question, is required. An investigation of potential offsetting efficiency gains should also be undertaken. We suggest that the burden of proof continue to be placed on the Commission or the Court to determine (starting with the filters) whether the merger or practice is likely to result in significant market power. The burden of proving offsetting efficiency gains should continue to rest with the firm concerned.

The same standard of proof must be applied in determining the costs associated with market power and any offsetting efficiency gains. The cost of preventing some efficiency-enhancing practices must be balanced against the cost of allowing some efficiency-reducing practices to slip through the antitrust net. The existing standards of proof adopted by the Commission probably cause too many efficient practices to be deterred or precluded.

Assessments of efficiency losses need only be concerned with "dominance" or the exercise of "market power" and offsetting efficiency improvements (the so-called "efficiencies defence"

in the United States). Concepts such as "substantial lessening of competition" or "public benefit" are superfluous and distracting.

2.5 Procedure

2.5.1 *Time for Approval of Mergers and Commercial Practices*

The commercial community is concerned about the time taken by the Commerce Commission to decide the more difficult antitrust and restrictive trade practice cases. Most of the major merger cases have taken the full 100 days allowed by the Act. No time limit at all is set for authorising trade practices.

The time taken to obtain approval from the Commission increases the costs of the process and may reduce the willingness of firms to appeal contestable decisions. A reduction in the time taken would improve the appeal process and increase the Commission's accountability.

Reducing the length of time involved in obtaining approval for a merger or restrictive trade practice must be a priority in any review of the Act. The 100 working day period is too long in terms of commercial considerations; the potential costs associated with delay can be very large. A most important change would be to reduce the 100 day period to at least the 80 days proposed by the discussion document or preferably to 60 days. In many cases the 100 day period has not been used effectively, and analysis could have been completed much more rapidly. The same time period should be imposed on restrictive trade practice clearances. A 60 working day period should be sufficient to allow a detailed examination of the efficiency implications of a merger or restrictive trade practice.

Any reduction in the initial 20 day period allowed for the consideration of a proposal would also bring substantial benefits. The Commission should be able to apply the filters and decide whether further analysis is likely to be needed within 20 days or less. A procedure that fast-tracked proposals that raised no concerns at all would also be worthwhile.

2.5.2 *Voluntary Clearance*

Reducing the time allowed the Commission to make its decisions requires either that additional resources be devoted to analysis or that existing resources be used more effectively. With around 75 staff plus Commissioners, the Commerce Commission is already a large agency. There is general dissatisfaction with the current clearance procedure which requires the Commission to report on proposals that have no impact on efficiency. We propose the adoption of a voluntary clearance system as a solution to the problems faced.

Notification of mergers and takeovers would be made voluntary. Firms could voluntarily apply to the Commission for clearance of mergers or trade practices. Alternatively they could elect to proceed without seeking a clearance. The Commission would have the power to obtain an injunction to prevent the merger or practice if it believed that it might be harmful. The Commission could bring a case to the High Court if it considered that a merged firm was exercising market power (restricting output and raising prices).

This approach would advantageously shift the focus of the Commission's analysis to situations in which firms were actually causing harm (exercising market power) rather than preventing mergers or restrictive trade practices that might potentially enable a firm to exercise market power. The system of voluntary clearance would allow firms and other organisations themselves to assess whether or not they complied with the law, relieving the Commerce Commission of a substantial burden.

Against this, firms bear the risk of incurring the costs associated with subsequent penalties which may include mandatory divestment (in the case of a merger). However, because the procedure allows voluntary clearance and a realisation by the parties involved of the

penalties that would apply if the Act is breached, this situation is unlikely to arise. If it does, then firms should face the real costs of their decisions.

The Commerce Commission may believe that a remedy other than a fine should be levied on a firm found to be in breach of the Act. For example, it may believe that divestment, price control, common carrier provisions or the reduction of tariff barriers or other legislative or regulatory barriers would be more appropriate. We believe the Commission or the Courts should not have the right to impose (all or any) such requirements but that the Commission could recommend to the government that such provisions be imposed or such policy changes adopted. The government could then decide on the most appropriate action.

The mandatory prior notification system proposed by the Department of Trade and Industry would improve on the current system. It would not require the Commission to report in detail on all cases. The Commission would be required to decide in the initial 20 day period (or less) which mergers or restrictive trade practices should be subject to further investigation. A merger would be deemed to have obtained approval if a specified time period had elapsed. Such a process would bring to the Commission's attention all mergers and trade practice activities. Dropping the mandatory requirement to report on all proposals would reduce the current workload of the Commission.

The usual arguments for a mandatory notification and clearance procedure for mergers are that proposals would otherwise escape attention and that action after the event to "unscramble the eggs" (for example via divestiture) is draconian and difficult for a regulatory authority to contemplate. (Concerns about "unscrambling eggs" are normally less strongly held in the case of trade practices.) We believe these objections are not compelling and are substantially outweighed by the gains from a less cumbersome procedure. Particularly in the small New Zealand commercial environment, any merger proposals likely to raise antitrust concerns will quickly come to the notice of a competent administering body and other interested parties. Delays, often of considerable length, are involved before proposals are consummated. The normal remedy in the event of concerns arising with unnotified mergers is not divestiture, as is often suggested, but injunctions. However, divestiture and other more severe remedies are entirely feasible and applied in practice overseas. A firm which had the opportunity to obtain a clearance but proceeded regardless via a merger to acquire and exploit a dominant position would have no cause for complaint if such penalties were imposed. We conclude that there could be major benefits and few risks in going further than the Department's proposal by making prior notification of both mergers and takeovers and restrictive trade practices a voluntary matter.

2.5.3 *Undertakings*

The decision of the Court of Appeal in the **Goodman Fielder/Wattie** case suggests the merits of including a provision in the Act to allow the Commission to accept undertakings in relation to any business arrangement. The discussion paper notes:

> "It is the Department's view that it is appropriate for proponents of a merger or takeover to include undertakings to sell certain assets or businesses which would otherwise give rise to concerns of market dominance as part of the proposal put before the Commission. However, it is considered inappropriate for the Commission to seek to impose conditions in relation to such matters as part of their determination." (1988, p 49)

We concur with the Department's position although we note that the right to give undertakings should extend beyond mergers and takeovers to cover trade practices.

2.5.4 *Expertise of Decision Makers*

The expertise and talent of members of the Commerce Commission, the Commission staff and judges in the High Court will be critical in determining the quality of decisions made under

the Act irrespective of the form of the Act that is adopted. The decisions of both the Commission and the Courts have demonstrated in some cases a lack of understanding of the relevant economic theory. It is important that, in administering the Act, the Courts and the Commission fully utilise modern economic theory and international experience and do not rely on simplistic or outmoded notions of competition. Legal education, including the need to incorporate economic programmes in law schools, is relevant here.

One of the major problems at the High Court level must relate to the limited number of cases that actually reach the Courts and the performance of individual judges in developing a sophisticated understanding of economic issues. The use of expert lay members of the Court can assist in improving the level of economic analysis adopted.

Improved terms and conditions of employment of Commission members may play a role in attracting people with legal, economic or commercial expertise. For example, the rates of remuneration of members may need to be increased. Alternatively, additional flexibility in the terms of employment may enable experienced people to join the Commission to hear a limited number of cases throughout the year.

The staff resources of the Commission of around 75 people are sizeable. If the more limited role for antitrust intervention and the streamlined procedures which we propose were adopted, it should be possible to achieve substantial administrative economies. Because the analysis of the efficiency issues associated with mergers and trade practices is often difficult, it is important that professional staff members have a strong background in economics and a knowledge of business.

The reduction in the workload of the Commission which would result from our proposed filter approach and a voluntary clearance system could ensure that a small number of high quality resources are used to best advantage.

2.5.5 *Accountability of the Commission*

The incentives for the Commerce Commission and its staff to perform to a high standard will be determined to some extent by their accountability. Currently the major sources of accountability are the public nature of the current system and the right to appeal to the High Court. The right of appeal mechanism is limited by the time taken to get a decision from the Commerce Commission and the expense of appealing to the Court. A reduction in the 100 day period for approval of mergers could increase the number of cases that are appealed and would allow greater feedback on the Commission's performance. The public nature of the current system should be preserved as much as is possible given other considerations such as workload.

Beyond these mechanisms, the Commission appears to be subject to little formal accountability. The Department of Trade and Industry notes that:

> "the Commission's current independence also raises questions concerning its overall accountability to the Government and to Parliament. Whether it is appropriate for an administrative body responsible for application of a significant element of the Government's policy and for substantial expenditure of public funds to be largely independent of Government control is a proper matter for question." (1988, p 20)

We agree that attention should be given to mechanisms that would improve the Commission's accountability.

One approach that we propose is to place a requirement on the Commission to present its estimates of the net national benefits which it considers would be derived from individual decisions to intervene. This would be done as part of the analysis justifying a decision to disapprove a merger or commercial practice. It is clear from recent cases that the economic *costs* of Commission decisions can run to many millions of dollars. It would be made incumbent on the Commission to show that the order of magnitude of likely *benefits* would exceed these

costs. The analytical techniques used to estimate the costs of monopoly in the empirical studies referred to in Chapter One would be among the tools that could be used for this purpose.

Another way to increase the accountability of the Commission would be to ensure that it bears the costs of any wrong decisions imposed on other organisations. The costs and risks of litigation should be equally distributed between the Commission and the defendant. The Commission should be liable for any damages incurred by a firm where a decision by the Commission is overturned by the High Court or where the Commission brings a case to the High Court and then loses it.

The Commission and the staff should be encouraged to subject their views to peer review through publishing papers on the implications of new developments in economic theory and commenting on the principles that have been adopted in major cases. A publication programme of the type undertaken by the Industries Assistance Commission in Australia would be useful in this regard. The members of the Commission should maintain an active professional involvement in seminars and other methods of disseminating information and stimulating debate on antitrust issues of current interest. Some members of the Commission have already made considerable efforts in this regard.

2.5.6 *Alternative Administrative Arrangements*

The current cumbersome procedure for clearing mergers and restrictive trade practices could result in merger applications being heard in full twice, first in the Commerce Commission and then before the High Court. Because the usual rules of evidence including the normal process of cross-examination of witnesses do not apply in Commerce Commission hearings, the facts must be looked at anew if the case is taken to the High Court. This duplicates the costs of discovering the facts relating to the case. It raises important questions about the problems of combining two different sorts of process.

We have not examined in detail how these problems should be dealt with. Two suggestions that could be analysed more fully are made.

One possible way to reduce the cost of the process would be to change the Commerce Commission hearing into a more structured legal process which uses all the customary rules of evidence. This could create a record of facts which could then be used by the High Court. The change in process may reduce the flexibility and informality of the current process but could reduce the cost of taking the case to the High Court and therefore increase the accountability of the Commerce Commission. On the other hand, if the proposed change increased the time taken for a decision to be made at the Commission level, little might be gained.

An alternative would be to move towards the approach adopted by the Federal Trade Commission in the United States. The first hearing of an antitrust case would be in the High Court. The Commerce Commission's role would be limited to deciding which cases it wished to pursue in Court. It would impose an injunction on a firm that it wished to prevent merging and then act as prosecutor in the High Court hearing.

The time taken by the Commission to examine a merger or takeover case could be substantially reduced because the Commission would not decide whether or not to grant approval; rather it would only have to determine that the merger (or trade practice) was likely to reduce efficiency. It would not therefore have to assess the issues as fully as it currently does. It would remove the prospect of two full hearings - the first at the Commission level and the second at the High Court.

The Commission would no longer be in the potentially conflicting roles of prosecutor and judge of antitrust cases. The greater number of cases that would reach the Courts would have the effect of building precedent and thereby increasing certainty as to the intent of the law.

Although the Commission's deliberations could similarly create precedents, the Commission does not appear to have been bound by its own precedents in practice.

The Court has a status that the Commission is unlikely to have. It may therefore be able to attract higher quality resources than the Commission. The quality of decisions made by the High Court (if a sufficient number of cases were to reach it) might be expected to be generally higher than those of the Commission. However, the quality of economic analysis likely to be used in the Court (at least initially) must remain a significant concern, and there may be a greater risk of reference to inappropriate international precedents. The possible success of such a proposal would be critically dependent on judges having an understanding of economics as well as law and the lay members of the Court having a high level of expertise.

Sanctions imposed by the High Court may also bear more weight than those applied by the Commission. To that extent, enforcement through the High Court may improve self-enforcement of the Act. The incentives for efficient intervention would also be improved. Currently the Commission faces incentives to increase its jurisdiction and importance by extending its reach into cases that do not merit its consideration. The Courts on the other hand are not constrained to consider only antitrust cases - a reduction in such cases will not significantly affect their overall workload or status.

Since the time taken for a decision is of serious concern to the business community, the advantages of the proposed change would depend on obtaining an expeditious hearing in the High Court.

Further detailed analysis of the merits of such an approach would be necessary to determine whether it would be appropriate for New Zealand. The current review of the court system by the Law Commission is relevant here. Any such study should also investigate whether the Commerce Commission or some other body is the most appropriate administrative machinery.

Section 3 Conclusions

The process of deregulation undertaken by the Government has significantly increased the competition facing organisations in the domestic economy. As a result the potential concerns with monopoly have been significantly reduced. A case for retaining a Commerce Act with a comprehensive jurisdiction can be made in principle, but there is a very real risk that antitrust policy could yield more harm than good, whether by condoning harmful practices or by obstructing potentially beneficial ones. We are concerned that such legislation imposes clear, tangible costs on society whereas the benefits claimed are sometimes difficult to demonstrate. Looking at the issue another way, it is not clear that the downside economic risks of dispensing with a general antitrust policy, and perhaps establishing some specific regulations for a small number of industries and rights of private action, would be significant. The Government and private parties would not be without powers to take action in the event of instances of monopoly behaviour, and the threat of such regulation could be an effective safeguard with lower overall economic costs.

We submit that the primary task of the Government in the present review is to establish whether the problems of monopoly in the current economy are a significant source of concern and whether it is possible to establish a well-designed law, a well-structured administrative apparatus and the availability of highly competent administrators such that net economic benefits can be assured from a regulatory regime. If it is concluded that a statute along the lines of the Commerce Act should be retained, we make the following recommendations:

* the Act should apply equally to input and product markets. Its jurisdiction should be comprehensive covering state organisations, professional bodies, statutory monopolies and labour market organisations, as well as other businesses;

* the objective of the Act should be clarified and stated in terms of the promotion of economic efficiency, with competition valued solely as a means to this end;

* the Act should contain a single set of provisions that apply to commercial practices and mergers;

* there should be no *per se* prohibitions of any practices. Business arrangements should be assessed using a rule of reason to determine their impact on efficiency;

* a series of filters should be adopted that will expedite analysis of whether business arrangements are likely to give rise to concerns. The filters will assist in self-enforcement of the Act;

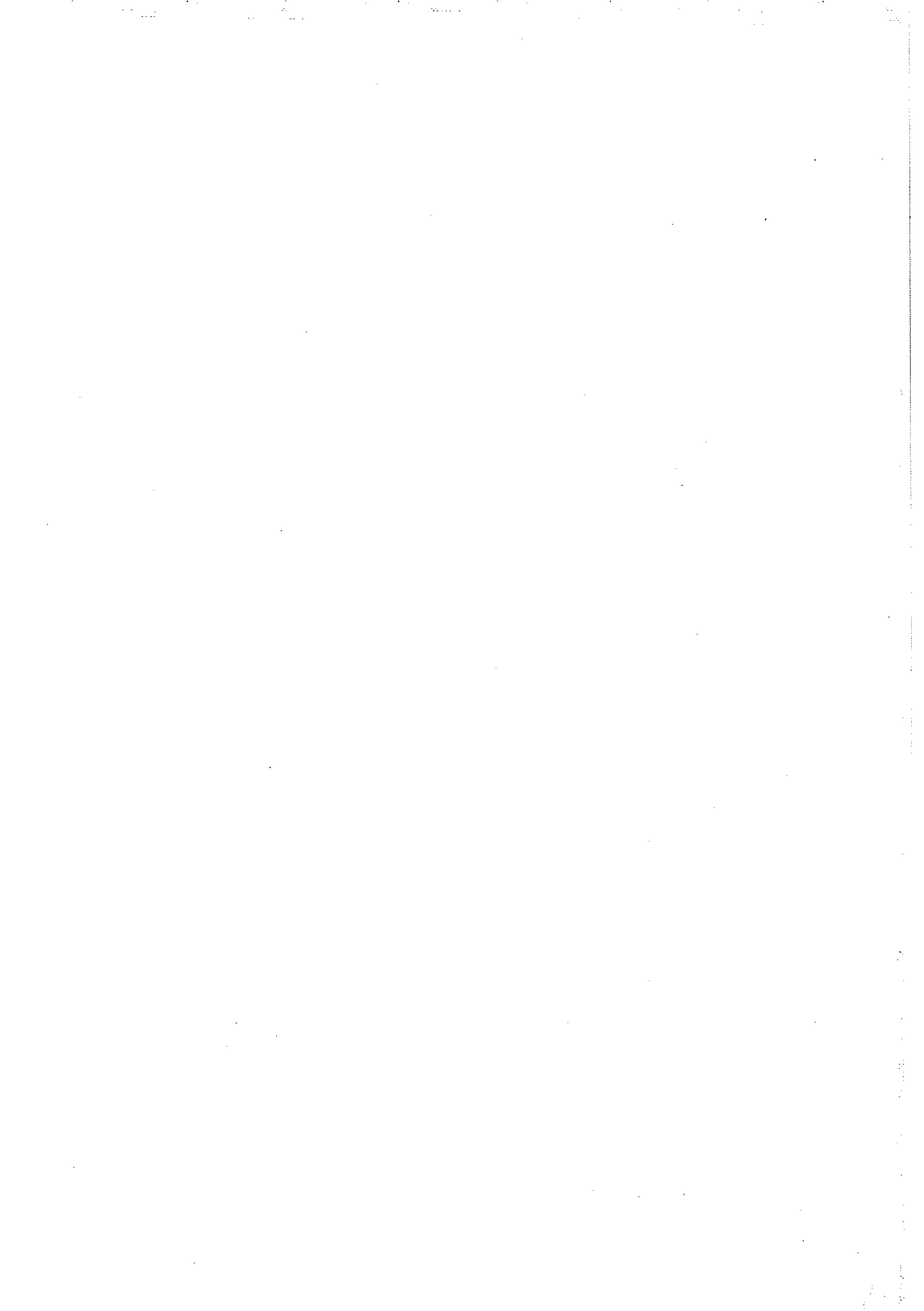
* the decision process should be expedited. In particular, the 100 day period should be reduced to 60 days;

* a system of voluntary clearance of mergers, takeovers and trade practices should be introduced to further reduce the burden of administering the Act and increase flexibility for businesses in deciding how to structure their arrangements. Injunctions to halt proposals and *ex post* remedies should be available;

* further consideration should be given to whether the Commerce Commission or some other body is most appropriate for administering the Commerce Act;

* the accountability of the Commerce Commission or any alternative administrative body should be increased,

* that the Act as amended in the current review should be subject to further review, for example by means of the inclusion of a sunset clause.



REFERENCES

Alchian, A.A. and Allen, W.R., *Exchange and Production: Competition, Coordination and Control*, 3rd Edition, Wadsworth, 1983.

Alchian, A. and Demsetz, H., "Production, Information Costs, and Economic Organisation", *American Economic Review*, 62, 1972, pp 777-795.

Anderson, T.L. and Hill, P.J., "The Evolution of Property Rights: A Study of the American West", *Journal of Law and Economics*, 12, 1975, pp 163-179.

Bain, J.S., "Relationship of Profit Rate to Industry Concentration: American Manufacturing 1936-1940", *Quarterly Journal of Economics*, 65, pp 293-324.

Baldridge, M., "The Administration's Legislative Proposal and its Ramifications", *Antitrust Law Journal*, 55, 1986.

Barwood, K.P., "Implementation of a Competition Policy", Paper presented to the New Zealand Association of Economists' Conference, Wellington, February 1986.

Baumol, W.J. and Ordover, J. A., "Use of Antitrust to Subvert Competition", *Journal of Law and Economics*, 28, 1983, pp 247-265.

Block, M.K. and Sidak, M.K., "The Cost of Antitrust Deterrence: Why Not Hang a Price Fixer Now and Then?", *Georgetown Law Journal*, 68, 1980, pp 1131-1139.

Bork, R.H., *The Antitrust Paradox: A Policy at War with Itself*, Basic Books, New York, 1978.

Borrie, Sir G., "Competition Policy in Britain: Retrospect and Prospect", *International Review of Law and Economics*, 2, 1982, pp 139-149.

Breit, W. and Elzinga, K.G., "Private Antitrust Enforcement: The New Learning", *Journal of Law and Economics*, 28, 1985, pp 405-443.

Campbell, T.J., "Economic Concepts and Antitrust Analysis: A Critical Reexamination", *Antitrust Law Journal*, 56, 1987.

Chard, J.S., "Economic Effects of Exclusive Purchasing Agreements in the Distribution of Goods", in Pellegrin, Luca and Srinivas, *Marketing Channels, Relationships and Performance*, Lexington Books, Lexington, 1986.

Cheung, S.N.S., "The Structure of a Contract and the Theory of a Non-exclusive Resource", *Journal of Law and Economics*, 13, 1970, pp 49-70.

Cheung, S.N.S, *The Myth of Social Cost*, Hobart Paper 82, The Institute of Economic Affairs, London, 1978.

Cheung, S.N.S., "The Contractual Nature of the Firm", *Journal of Law and Economics*, 26, 1983, pp 1-21.

Cheung, S.N.S., *Will China Go 'Capitalist'?*, Hobart Paper 94, 2nd Edition, The Institute of Economic Affairs, London, 1986.

Coase, R.H., "The Nature of the Firm", *Economica*, 4, 1937, pp 386-405.

Clark, D., "Price-Fixing Without Collusion? An Antitrust Analysis of Facilitating Practices", *Wisconsin Law Review*, 1983, pp 887-952.

Comanor, W.S., "Vertical Price-Fixing, Vertical Market Restrictions, and the new Antitrust Policy", *Harvard Law Review*, 98, 1985, pp 983-1002.

Comanor, W.S. and Frech, H.E., "The Competitive Effects of Vertical Agreements", *American Economic Review*, 75, 1985, pp 539-546.

Cowling, K. and Mueller, D.C., "The Social Costs of Monopoly Power", *The Economic Journal*, 88, 1978, pp 727-748.

Crane, M., "The Future Direction of Antitrust", *Antitrust Law Journal*, 56, 1987.

de Alessi, L., "The Economics of Property Rights: A Review of the Evidence", *Research in Law and Economics*, 2, 1980, pp 1-47.

de Alessi, L., "Property Rights, Transaction Costs, and X-Efficiency: An Essay in Economic Theory", *American Economic Review*, 73, 1983, pp 64-81.

Demsetz, H., "Why Regulate Utilities?", *Journal of Law and Economics*, 11, 1968, pp 55-65.

Demsetz, H., "Economic, Legal and Political Dimensions of Competition", in *Lectures in Economics: Theory, Institutions, Policy*, de Vries, F. (ed), North Holland, 1983.

Department of Trade and Industry (UK), *Review of Restrictive Trade Practices Policy: A Consultative Document*, London, HMSO Cm 331, 1988.

Dunlop, B., McQueen, D. and Trebilcock, M., *Canadian Competition Policy*, Canadian Law Book Inc, Toronto, 1987.

Easterbrook, F., "The Limits of Antitrust", *Texas Law Review*, 63, 1984, pp 1-40.

Easterbrook, F., "Detrebling Antitrust Damages", *Journal of Law and Economics*, 28, 1985, pp 445-467.

Easterbrook, F.H. and Fischel, D.R., "Antitrust Suits by Targets of Tender Offers", *Michigan Law Review*, 80, 1982, pp 1155-1178.

Eastman, M.C. and Stykolt, S., *The Tariff and Competition in Canada*, Macmillan, Toronto, 1967.

Fairburn, J.A., "British Merger Policy", *Fiscal Studies*, 6, 1985, pp 70-81.

Fama, E.F. and Jensen, M.C., "Separation of Ownership and Control", *Journal of Law and Economics*, 26, 1983, pp 301-325.

Fama, E.F. and Jensen, M.C., "Agency Problems and Residual Claims", *Journal of Law and Economics*, 26, 1983a, pp 327-349.

Fisher, F.M., "Diagnosing Monopoly", *Southern Economic Journal*, 45, No 4, 1979, pp 7-33.

Fisher, F. M., "The Social Costs of Monopoly and Regulation: Posner Reconsidered", *Journal of Political Economy*, 93, 1985, pp 410-416.

Fisher, F.M., "Horizontal Mergers: Triage and Treatment", *Economic Perspectives*, 1, 1987, pp 23-40.

Fisher, F., McGowan, J. and Greenwood, J., *Folded, Spindled, and Mutilated:Economic Analysis and US v. IBM*, Cambridge (Mass.), MIT Press, 1983.

Franks, S. L. and Baxt, R., *Submission to the Law Commission on Company Law*, New Zealand Business Roundtable, Wellington, 1988.

Galanter, M., "Justice in Many Rooms: Courts, Private Ordering, and Indigenous Law", *Journal of Legal Pluralism*, 19, 1981, pp 1-47.

George, K.D., "Monopoly and Merger Policy", *Fiscal Studies*, 6, 1985, pp 34-48.

Green, C., "Canada's Competition Laws, Old and New", Paper to the New England Antitrust Conference, 1986.

Green, C., "Industrial Organisation Paradigms, Empirical Evidence, and the Economic Case for Competition Policy", *Canadian Journal of Economics*, 20, 1987, pp 482-505.

Hammond, C.H., "An Overview of Electric Utility Regulation", in *Electric Power, Deregulation and the Public Interest*, Moorehouse, J.C. (ed), 1986, pp 31-61.

Hanson, C.G. and Mather, G., *Striking Out Strikes*, The Institute of Economic Affairs, London, 1988.

Hay, D. and Vickers, J., *The Economics of Market Dominance*, Basil Blackwell, Oxford, 1987.

Heldman, D.C., Bennett, J.T. and Johnson, M.N., *Deregulating Labour Relations*, The Fisher Institute, Dallas, 1981.

Jennings, S.A. and Begg, S.J., "An Economic Review of Commerce Commission Decisions Under the Commerce Act 1986", Report Prepared for the Treasury, May 1988.

Jensen, M.C. and Meckling, W.H., "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics*, 3, 1976, pp 305-360.

Joskow, P.L. and Noll, R.G., "Economic Perspective on the Politics of Regulation", Paper presented to the New Zealand Association of Economists' Conference, February 1987.

Kamerschen, D.R., "An Estimation of the Welfare Losses from Monopoly in the American Economy", Western Economic Journal, 4, 1966, pp 221-236.

Klein, B., "Transaction Cost Determinants of 'Unfair' Contractual Arrangements", *American Economic Review*, 70, 1980, pp 356-362.

Klein, B., "Vertical Integration, Organizational Ownership and Transaction Costs: The Fisher Body-General Motors Relationship Revisited", *Journal of Law, Economics and Organization*, (forthcoming Spring 1988), draft paper, 1987.

Klein, B., "The Use of Economic Models in Antitrust Litigation", Paper presented to the Fraser Institute/University of Toronto Symposium on Economic Competition and the Law, Toronto, 1988.

Klein, B., Crawford, R.G. and Alchian, A.A., "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process", *The Journal of Law and Economics*, 21, 1978, pp 297-326.

Klein, B. and Jennings, S., "Comments on the Statement of David K. Round Regarding the Use of Exclusive Dealing by Fisher & Paykel Limited", Wellington, 1988.

Klein, B. and Leffler, K.B., "The Role of Market Forces in Assuring Contractual Performance", *Journal of Political Economy*, 89, 1981, pp 615-639.

Krattenmaker, T.G. and Salop, S., "Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price", *The Yale Law Journal*, 96, 1986, pp 209-293.

Leffler, K., "Towards a Reasonable Rule of Reason: Comments", *Journal of Law and Economics*, 28, 1985, pp 381-386.

Littlechild, S.C., "Misleading Calculations of the Social Costs of Monopoly Power", *The Economic Journal*, 91, 1981, pp 348-363.

Long, W.F., Schramm, R. and Tollison, R., "The Economic Determinants of Antitrust Activity", *Journal of Law and Economics*, 16, 1973, pp 351-364.

Marvel, H.P., "Exclusive Dealing", *Journal of Law and Economics*, 25, 1982, pp 1-25.

Neale, A.D. and Goyder, D.G., *The Antitrust Laws of the USA*, 3rd Edition, Cambridge, Cambridge University Press, 1980.

New Zealand Business Roundtable, <u>Telecommunications in New Zealand : The Case for Reform</u>, Wellington, New Zealand Business Roundtable, 1987.

O'Brien, D.P., "Competition Policy in Britain : The Silent Revolution", *The Antitrust Bulletin*, 1982, pp 217-239.

Officer, R., "The Public Benefit Test in an Authorisation Decision", Paper presented to the Trade Practices Workshop, Melbourne, 1987.

Parry, T.G., "CER and Competition Policy: A Need for Harmonisation?", Paper presented to the New Zealand Centre for Independent Studies Conference on "Regulating for Competition", Auckland, 1988.

Polinsky, M. and Shavell, S., "The Optimal Tradeoff Between the Probability and Magnitude of Fines", *American Economic Review*, 69, 1979, pp 880-881.

Posner, R.A., "The Federal Trade Commission", *University of Chicago Law Review*, 39, 1969, pp 47-89.

Posner, R.A., *Antitrust Law: An Economic Perspective*, The University of Chicago Press, 1976.

Posner, R.A., *Economic Analysis of Law*, 3rd Edition, Little, Brown and Company, 1986.

Reich, R.B., "The Antitrust Industry", *Georgetown Law Journal*, 68, 1980, pp 1053-1073.

Salop, S. C., "Measuring the Ease of Entry", *The Antitrust Bulletin*, 1986, pp 551- 570.

Salop, S. C., "Symposium on Mergers and Antitrust", *Economic Perspectives*, 1, No 2, 1987, pp 3-12.

Scherer, F.M., *Industrial Market Structure and Economic Performance*, 2nd Edition, 1980.

Schmalensee, R., "Standards for Dominant Firm Conduct: What Can Economics Contribute?" in *The Economics of Market Dominance*, Hay, D. and Vickers, J. (eds), Basil Blackwell, 1987, pp 61-88.

Schmalensee, R., "Horizontal Merger Policy: Problems and Changes", *Economic Perspectives,* 1, No 2, 1987a, pp 41-54.

Schmalensee, R., "Ease of Entry: Has the Concept Been Applied too Readily?", *Antitrust Law Journal,* 41, 1987b, pp 41-51.

Schwartz, W.F., "An Overview of the Economics of Antitrust Enforcement", *Georgetown Law Journal,* 68, pp 1075-1102.

Sharpe, T., "Privatisation, Regulation and Competition", *Fiscal Studies,* 5, 1984.

Shaw, R. and Simpson, P., "The Monopolies Commission and the Process of Competition", *Fiscal Studies,* 6, 1985, pp 82-96.

Siefried, J.J., "The Determinants of Antitrust Activity", *Journal of Law and Economics,* 17, 1975.

Smith, V.L., "Currents of Competition in Electricity Markets", *Regulation,* 2, 1987, pp 23-29.

Stigler, G.J., "The Optimal Enforcement of Laws", *Journal of Political Economy,* 78, 1970, pp 526-536.

Toumanoff, P.G., "A Positive Analysis of the Theory of Market Failure", *Kyklos,* 37, 1984, pp 529-541.

United States Merger Guidelines issued by the Department of Justice, June 1984, and Accompanying Policy Statement, in *Antitrust and Trade Regulation Report,* No 1169, 1984.

United States Department of Justice Vertical Restraints Guidelines, in *Antitrust and Trade Regulation Report,* 48, No 1199, 1985.

Vautier, K., "Competition Policy and Competition Law in New Zealand", in Bollard, A. and Buckle, B. (eds), *Economic Liberalisation in New Zealand,* Allen and Unwin, Wellington, 1987, pp 46-66.

Veljanovski, C., *Selling the State: Privatisation in Britain,* Weidenfeld and Nicolson, London, 1987.

Vickers, J., "Strategic Competition Among the Few-Some Recent Developments in the Economics of Industry", *Oxford Review of Economic Policy,* 1, no 3, 1985, pp 39-62.

Vickers, J. and Yarrow, G., *Privatisation: An Economic Analysis,* Cambridge (Mass.), MIT Press, 1988.

von Weizacker, C.C., "A Welfare Analysis of Barriers to Entry", *The Bell Journal of Economics,* 11, 1980, p 399-420.

White, L.J., "Antitrust and Merger Policy: A Review and Critique", *Economic Perspectives,* 1, 1987, pp 13-22.

Whiting, R.A., "Introductory Remarks, Thirty-third Annual Spring Meeting", *Antitrust Law Journal,* 54, 1985.

Williams, P.L., "Why Regulate for Competition?", Paper presented to the New Zealand Centre for Independent Studies Conference on "Regulating for Competition", Auckland, 1988.

Williamson, O.E., *Markets and Hierarchies: Analysis and Anti-trust Implications*, The Free Press, New York, 1975.

Williamson, O.E., "Economies as an Antitrust Defense Revisited", *University of Pennsylvania Law Review*, 125, 1977, pp 699-736

Williamson, O.E., "Credible Commitments: Using Hostages to Support Exchange", *American Economic Review*, 73, 1983, pp 519-540.

Williamson, O.E., "The Incentive Limits of Firms: A Comparative Institutional Assessment of Bureaucracy", *Weltwirtschlaftliches Archiv*, 120, 1984, pp 736-763.

Williamson, O.E., *Antitrust Economics*, Basil Blackwell, Oxford, 1987.