International Chamber of Commerce Australia

Submission to the
Trade Practices Act (1974)
Review

July 2002

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Sir Daryl Dawson AC KBE CB
Chairman
Committee of Inquiry
Trade Practices Act Review
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Dear Sir

ICC Australia TPA Submission

It is my very great pleasure to commend to you and your colleagues this submission by ICC Australia to your inquiry for the review of the competition provisions of the Trade Practices Act.

A review of the Trade Practices Act is timely. The globalization of markets that has occurred in the last decade or so can be thought of as the globalization of competition. This means that we are forced to frame our competition policy in the context of global practice, legislation and regulation.

The value explosion in technology, information and intellectual property means that more and more goods and services – from software to financial services; from movies to pharmaceuticals – are subject to increasing returns, rather than the laws of scarcity and diminishing returns that characterized most markets for most of human history. This means that there is stronger and stronger motivation for mergers, and more and more examples where consolidation is clearly in the interests of business *and* consumers.

Taken together, this radical transformation in the identity and the scope of markets suggests that a rethink of competition policy is well in order.

Perhaps more fundamental, the economic presuppositions on which the Trade Practices Act is based are coming under increasing scrutiny. And many economists – including several Nobel winners over the past thirty years – now believe the neo-classical model that has prevailed in Western democracies for several decades is at best outworn and no longer useful; at worst finally discredited. Both the Act and the Competition Regulator operate on the assumption that Competition needs to be carefully protected by a central authority, lest unscrupulous companies in their wanton pursuit of profits injure this fragile ideal.

ICC argues rather that Competition is inherently robust. And those (usually large) companies perceived as a potential threat to Competition are in fact its most obedient servants, strengthened and refined through the fires of the tough and unforgiving marketplace – a sort of Darwinian evolution; for though Competition is the best provoker of innovation and experimentation, its extraordinary power is essentially responsive and subservient to the will of the consumer.

To try to protect Competition then – to seek to intervene between supplier and user, and manipulate the intrinsic balance of the market – is to invite a great many unintended and disagreeable consequences. The very attempt suggests that Competition is an end in itself, where in fact ICC argues (with the majority, we believe) that Competition is a mechanism that naturally regulates the flow of scarce resources into the most propitious channels, to the ultimate benefit of the whole of Society. To 'protect' Competition will lead to absurdities, such as supposing the ultimate goal of Competition policy is to preserve four banks, for instance, or four auto manufacturers, as though that in itself were somehow a sacred guarantor of the rights and interests of the consumer.

Perhaps, though, the worst of these unintended and disagreeable consequences is the threat that we might succeed: for the man-in-leotard with the chair and the whip will either be eaten by the lion or will subdue and tame it. If Australia's competitive spirit should ever be quenched or emasculated, this would most emphatically not be a victory for the consumer, and would in fact deal a serious blow to our hard-won status among the first rank of nations.

Given the fundamental shifts described above, it is remarkable that the ACCC is seeking to strengthen the interventionary provisions of the Act, and augment its own powers. More extraordinary is that they are claiming broad support from consumers and small business. If this is true, why might it be so?

First, every organization has a natural tendency to seek to develop its own domain and widen its sphere of control. The ACCC has enjoyed considerable success in recent years in raising its profile and extending its influence. It is not mere cynicism to suggest that it is enjoying this trend.

Second, any Regulator is a natural ally to the disaffected: "there ought to be a law against that", "the government should do something", etc. However instinctive this might be, it is rarely wise to indulge this popular cry, though it is often politically expedient for Opposition parties to stir it up, and for weak governments to capitulate to it.

Third, while the free market spreads wealth and opportunities to a breadth of beneficiaries, which is obvious when viewed in generality, it is in every business's *particular* interest that its own case should be an exception, and that its own market should be protected. This is seen most clearly in arguments about tariffs and subsidies: everyone agrees that the playing field should be level, but each business can find special reasons why it alone should qualify for a handout!

Fourth, the ACCC has assiduously lobbied small business; Professor Fels has entertained consumers, through means fair and foul. It should be noted that while small businesses typically have a better understanding and grasp of the market "up close", big business usually has a better understanding of the economic principles of the marketplace; and big business tends to have the resources to hire economists, while small business is usually devoting all its resources to the challenge of making a profit. This will necessarily influence both the views and the quality of public policy submissions.

Big business might be expected to resist vigorously many of the ACCC's recommendations and to argue for a loosening of the Act. Yet submissions by big business have been extremely cautious, most of them even arguing in favour of the current Act. Why? Because large companies recognize that the potential downside of an unfavourable Review far outweighs the benefits that would be produced by a favourable one. One very prominent big business lawyer said to me we shouldn't try to change the competition test, not because it isn't worth changing, but because "it won't happen"!

ICC contends, then, that there is a strong case for deregulation and loosening of Competition policy. We respectfully caution the Review against either pumping up the interventionary provisions of the Act or attaching stronger penalties to those who are judged to have broken it, particularly as the Act, as it stands, would contain the weakest definitions of any branch of criminal law. I conclude this letter by remarking that the proposal to apply criminal law only to those above a certain threshold, and only for certain kinds of breaches of the Act deemed "morally reprehensible" is an intellectual nonsense, with a stunting effect on the growth of Australian corporations at the very time we should be most anxious to see them take to the newly-integrated global marketplace equipped with courage and confidence, and the will to prevail.

We look forward to the opportunity to contribute further to your important task in any way that may be helpful.

Yours faithfully

Martin R Cox
Chief Executive

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1. Executive Summary

ICC Australia calls for a fundamental overhaul of the TPA Part IV in the light of developments in the discipline of economics.

- The consensus within the discipline of economics that obtained in the era when the TPA was enacted has broken down. Within contemporary economic analysis, there have emerged serious critiques of key concepts and methodologies that underpin SS45 – 48 of Part IV. ICC's recommendation then is that Part IV of the TPA be redrafted to provide the following ***legal*** **presumption**:

  That all business practices in a free market (*including* 'hard core' cartel behaviour, mergers and all others currently proscribed under Part IV) do *not* damage overall community welfare – and will be expected to produce net economic benefit to the community – and are therefore permissible.

  The plaintiff's burden, then, would be to prove overturn this, by proving positively and demonstratively that in the case in question a company's action(s) has or would substantially harm net community welfare.

ICC opposes proposals to restrict business activity further through the *strengthening* of the provisions of the Act.

- On both legal and economic grounds, ICC Australia rejects the criminalization of 'hard core' cartel activity.

  - The Review committee should note the widely diverging views on the role of free market cartels, and the provenance of those views.
  - Negative, moralistic judgements of cartel behaviour stem from outdated economic theories. Dynamic models of competition see a positive role for cartels within the market economy.
  - It is inappropriate to consider criminalizing cartel behaviour when the economic model that condemns it is itself losing credibility.

- ICC insists that there is no justification in economic theory for the *strengthening* of the provisions of the Act by the addition of an effects test for S46.

- Likewise, ICC believes that proposals to weaken provisions of the Act – for example the revival of the 'dominance' test – are movements in a direction consistent with developments in economic thought.

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2. Introduction

ICC Australia is particularly conscious of the need to make the Australian economy a healthy and encouraging environment for doing business. In key respects, the playing field is not level in Australia's corner. We are isolated geographically from major transport routes and world economic centres in Europe, the Americas and north Asia. Our domestic market is not of a size as to provide for economies of scale required by some industries, such as heavy manufacturing. Nevertheless, in significant ways, Australia can define its economic destiny. By committing itself to substantive economic reform in those areas under its control, Australia can overcome its characteristic disadvantages and set the international benchmark for progress in the 21st Century.

ICC welcomes the Review of the Trade Practices Act (TPA) Part IV as a great opportunity to reform the legal framework of the Australian economy in the light of important developments in economic thought.

This set of provisions in the Act is distinguished by the degree to which its conceptual framework relies on the discipline of economics. The TPA was enacted at a time when there was – relatively speaking – an identifiable consensus within Western economic thought as to the definition and identification of such entities as 'competition', 'monopoly', 'market power', 'barriers to entry', and so on. There was an understanding that 'market failure' was the proper object of legislation, and that certain market failures – the exploitation of market power, specific activities such as, for example, 'predatory pricing' and 'exclusive dealing' and 'anti-competitive' structures such as 'cartels' – could be identified and eliminated. Moreover, most mainstream economists subscribed to the neo-classical methodology with its characteristic emphasis on mathematics and modelling.

It is undeniable that the post-war economic consensus – over methodology, the scope of 'market failure' and the ability of the state to manage the economy – has fallen apart. Most economists now hold to a broadly pro-market perspective, and there appears to be a continuing trend in that direction.[1] But what characterizes economics today is a level of dispute over concepts and methodologies not shared by many other sciences.[2]

The current version of the Trade Practices Act (TPA) and the way it is applied reflects a level of suspicion about the market economy that is no longer entertained by a predominant consensus of the economic profession. It is now a much-debated issue as

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[1] Consider the increasingly pro-market stance in recent editions of once staunchly Keynesian liberal economic textbook: Paul Samuelson's *Economics*. See Mark Skousen, 'Welcome back, Professor': http://www.mskousen.com/Books/Articles/welcome.html.
As Skousen notes, however, 'There's only one problem: A lot of policy is still being made … by men and women who absorbed an earlier form of the Samuelson gospel.'

[2] This is no more effectively illustrated than by considering the juxtaposition of the radical 'Austrian' F.A. Hayek and the socialist Gunnar Myrdal as recipients of the Nobel Prize for Economics in 1974. Since that time, the Nobel committee has continued the trend of awarding the prize to economists holding a diverse range of views about economic phenomena. Compare Milton Friedman (1976), George Stigler (1982) and James Buchanan (1986), for example, with Amartya Sen (1998).

to whether the market economy left to itself is susceptible to systemic and serious 'failure'. In any case, 'government failure' – the limitations in the ability of the state to oversee and remedy supposed market failures and to improve on the market – has become a study in itself.[3] Indeed, such has been the shift in perspective that many laws and judicial decisions once seen as promoting 'competition' and economic welfare are now adjudged to have had the reverse effect.

Moreover, key provisions of the TPA are predicated on a conceptual framework about which there is now considerable uncertainty or controversy within the economics profession. In consequence, businesses must either take a risk that their activities fall within the Act, or devote considerable resources to anticipating what the Australian Competition and Consumer Commission (ACCC) and courts might opine as anti-competitive behaviour.[4]

> The requirements of the Rule of Law that rules should be certain and clear, and that judicial decisions be based on evidence and fact, are no longer met by the TPA.

ICC is not suggesting that the Review take a position on all the controversies that relate to the economic rationale of the TPA. Our thesis is, rather, that the characteristically volatile nature of the discipline of economics must have implications for the framing of good law, which pertains to economic welfare. Respectable economic schools of thought now take fundamentally different - even opposite - views on the evaluation of business activities, definitions, the possibilities of quantification and other issues. The law should take into account this doubt and debate where it exists by displaying a proportionate degree of caution in the identification and penalization of so-called 'anti-competitive activities'. A commercial activity should not be prohibited except where there exist rigorously established reasons for confidence that it has net negative impacts on community welfare.

ICC recommends that Pt IV of the TPA be reformed to reflect the developments and levels of consensus in contemporary economics.

Rather than assuming that the economic concepts which underpin the Act are uncontroversial, and that there is a widespread consensus as to the economic harm caused by the proscribed acts, the presumption should be reversed. The Act (Part IV) should be rewritten according to the following principles:

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[3] Note the contributions of the Public Choice School of economists such as Nobel Prize winner James Buchanan.

[4] In the context of US competition law, Stigler writes: 'Antitrust policy is expensive to enforce: the Antitrust Division of the Department of Justice had a budget of $54 million in 1991, and the Federal Trade Commission budget was $74 million. The defendants (who also face hundreds of private antitrust cases each year) probably spend ten or twenty times as much. Moreover, antitrust is slow moving. It takes years before a monopoly practice is identified, and more years to reach a decision; the antitrust case that led to the breakup of the American Telephone and Telegraph Company began in 1974 and was still under judicial administration in 1991.' George Stigler, 'Monopoly' (www.econlib.org/library/Enc/Monopoly.html).

There is now a broad consensus of economic thought at least that the market economy in principle promotes economic welfare. There is considerable and growing scepticism as to the definition of and harm wrought by,‘anti-competitive’ acts proscribed under Part IV.

ICC’s recommendation is that Part IV of the TPA be redrafted to provide the *legal* presumption that all business practices in a free market (*including* ‘hard core’ cartel behaviour, mergers and all others currently proscribed under Part IV) are not anti-competitive, do *not* damage overall community welfare – and will be expected to produce net economic benefit to the community – and are therefore permissible *unless the plaintiff can prove demonstratively that in the case in question a company’s action(s) has or would substantially harm net community welfare.*

By altering the orientation of the TPA in this manner, ICC believes that the Act would provide a mechanism whereby the courts could more readily reflect in their decisions the state of expert contemporary economic thought.

This submission will seek to justify this recommendation. It focuses on economic concepts and methods that are elemental to the rationale of the TPA. It illustrates how many of the theoretical assumptions that undergird the TPA and its application have been subjected to significant criticism from respected bodies of economic theory. It argues that to penalize activities – the definition and evaluation of which is a matter that deeply divides respected economists – involves an arbitrary exercise of power, and violates the Rule of Law.

To clarify its position, ICC will engage in a critique of the submission offered by the Regulator, the ACCC. Note, however, that the scope of the ICC submission varies from that of the ACCC submission. Our proposal is directed to a fundamental reordering of the relationship between the TPA, curial interpretation and the discipline of economics.

> To penalize activities, the definition and evaluation of which is a matter that deeply divides respectable schools of thought, involves an arbitrary exercise of power, and violates the Rule of Law.

3. Problematic concepts within Part IV of the Act

3.1 'Competition' Theories: 'Perfect' vs. 'Dynamic'

An underlying premise of the TPA is that the public interest is invariably secured through the creation of a competitive economy. Competition delivers the most optimal allocation of a community's resources. ICC endorses this assumption.

But it is no longer acceptable to assume that there is a stable consensus over the term 'Competition'. For many years, two prominent, yet fundamentally incompatible concepts have divided the allegiances of economists. As Thomas DiLorenzo[5] notes, at least from the time of Adam Smith up to the 1920s most economists viewed competition as a dynamic process in which entrepreneurs sought to oust their rivals from the market via the creation of products that would most satisfy consumer needs. Thus, the measure of a firm's competitiveness would be the degree of market share it achieved.

However from the 1920s – with the arrival of neo-classical ('Walrasian or 'general equilibrium') economics – the so-called 'perfect competition' model replaced this theory. In this static model, Competition was defined in terms of the structure of the market. It was assumed that competitors had full knowledge of relevant conditions. Industries were deemed competitive when marginal price equated with marginal cost, there were 'many' firms, and there was no 'concentration'.

It is important to note that the two concepts are not mere variations of one substantial theme: they are *mutually exclusive*. The Dynamic Model economist would classify as eminently competitive a firm that achieved dominance or monopoly in a free market through superior business performance. Yet the Static Model economist would describe precisely this achievement as inimical to competition, since the firm has wiped out its rivals.

In the last 25 years, the earlier dynamic concept of competition has been rehabilitated as a viable alternative to the neo-classical model. There is now an emerging consensus that the neo-classical model is fraught with unrealistic assumptions. Above all, ironically, the neo-classical model with its assumptions about perfect knowledge effectively rules out human action – the very object which economic science wishes to study.

The revival of dynamic theories has been led by 'Austrians' with growing support from 'Chicagoites', 'Supply-Siders' and others. At least three recent Nobel Prize-winning economists (Friedman, Stigler and Hayek) more or less reject the neo-classical model of competition in the context of antitrust[6].

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[5]DiLorenzo, T.J. 1991 'The Antitrust Economists' Paradox' *Austrian Economics Newsletter*, 1991 (Summer): pp 1-6.

[6] Nobel laureate George Stigler of the Chicago school has written: "… at the risk of being called fickle, many economists (I among them) have lost both our enthusiasm for antitrust policy and much of our fear of oligopolies." Stigler, 'Monopoly' op.cit.

3.2 Competition and 'Concentration'

For example, the focus on 'concentration' and 'market share', a hallmark of the neo-classical approach, has come under heavy fire from antitrust economists, on the level of pure theory and – more often – by empirical analysis.

> 'Concentration is a poor predictor of anticompetitive effects…'
>
> Ky Ewing

Thus, in an exhaustive survey of economic studies, Harris and Smith concluded that there is insufficient evidence for the proposition that concentration affects the level of competition in an industry:

> "…many of the studies show only a small positive relationship between market concentration and price. These studies, moreover, do not show a unique relationship that holds across studies, much less across industries."[7]

Ky Ewing went further, after surveying the 'new learning' in the U.S. about concentration, concluding that

> "…concentration is a poor predictor of anticompetitive effects; it does not reliably tell us much, if anything, about when the Sherman or Clayton Acts will be violated."[8] [9]

More recently, in a survey of the Japanese economy Porter and Sakakibara have suggested that high concentration might even bear a *positive* relation to competition:

> "High industry concentration is positively associated with market share fluctuations, contrary to the predictions of the literature on the influence of concentration."[10]

In its submission, the ACCC has acknowledged that there has been a movement in both economic and curial thinking away from the static, non-realistic perfect competition model. [11] It accepts in its place a compromise theory of 'workable or effective' competition:

> "Workable competition means a situation where the presence of other participants, or potential new entrants, is sufficient to ensure that each participant is constrained to act efficiently. Any imbalance in access to resources, distribution outlets, finance etc. is not necessarily treated as anti-competitive, as long as there is the opportunity for sufficient influences to exist in a market."[12]

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[7] B Harris & D Smith, 'The Merger Guidelines v. Economics: A Survey of Economic Studies' in *Perspectives on Fundamental Antitrust Theory*, American Bar Association Section of Antitrust Law, 2001, p.47.

[8] Ky Ewing Jr: 'Re-examining the Concentration Thesis: What do *California Dental* and the 'New Learning' teach about the Merger Guidelines?' in *Perspectives on Fundamental Antitrust Theory,* op. cit., p. 121.

[9] The Sherman and Clayton Acts are US Antitrust Acts.

[10] M Sakakibara & M Porter, 'Competing At Home To Win Abroad: Evidence From Japanese Industry' in *Perspectives on Fundamental Antitrust Theory,* op. cit. p.198.

[11] ACCC: *Submission to the Trade Practices Review 2002,* p.198.

[12] ACCC, ibid. p. 198.

However neither the ACCC nor the courts seem to appreciate the fundamental incompatibility of the two theories of competition. Their *via media* of 'workable or effective' competition is an inherently unstable blend of the two theories.[13] This is illustrated in the confusion surrounding the concept of 'market power'.

3.3 Competition and 'Market power'

Often the courts have defined 'competition' in terms of an alleged opposite situation of 'market power'. Market power may be seen to correspond to the legislative wording 'substantial lessening of competition'.

The concept is crucial to the application of the TPA and explicitly so in S46.[14]

The ACCC submission endorses the following definition of 'market power' from Kaysen and Turner:

> "A firm possesses market power when it can behave persistently in a manner different from the behaviour that a competitive market would enforce on a firm facing otherwise similar cost and demand conditions."[15]

Unfortunately, notwithstanding the ACCC's cognizance of significant upheaval in the theory of competition, it is happy to rely without further qualification on a definition it has drawn from a work published in 1959 – the era when neo-classical competition theory held sway.[16]

The Kaysen/Turner definition is unacceptable to adherents of the dynamic theory of competition. Under the lure of its static ideal – the situation of 'perfect' competition – the Kaysen/Turner definition implies that the 'competitive' market situation is the preferred state: deviations are undesirable.

The dynamic model on the other hand insists that the market is a *process* and that no one state in that process is better than any other.

In any given industry, there may be periods when many firms compete and profit levels tend toward the interest rate of the economy, followed by periods when through some innovation one or more firms leap ahead of the pack and enjoy entrepreneurial profits and 'market power'. The more successful the innovation, the greater the 'power' to enjoy the profits. Conversely, the greater the entrepreneurial profit, the more incentive there is for competitors to close the gap on the market leader(s) by their own innovations.

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[13] It is as if 'workable' competition is the nearest approach in this world to the Platonic ideal of perfect competition. But why is this to be an ideal at all if it precludes the essence of economic behaviour – human action?

[14] While S46 does not condemn the mere possession of market power, it prohibits the taking advantage of market power for proscribed purposes.

[15] Kaysen and Turner, *Antitrust Policy* (1959)

[16] Note that the High Court also continues to accept this definition: *QWI v BHP* (1989) 167 CLR 177 Note 3.

Two observations must be noted about the market process:

1. There is no 'normal' length of time for either period. Innovative firms may stay ahead of the pack for days, weeks, or even centuries. On the other hand, close competition may also be a long-term feature of a given industry.
2. Periods of close competition are *no more or less optimal* than periods of individual entrepreneurial success.[17]

The Kaysen/Turner definition of market power reflects the existence of these stages of the market process. But the use of a word such as 'persistent' reveals a bias towards those periods when firms are surrounded by close competitors. The implication is that periods when there is 'market power' are departures from the desirable state when there is little separating one firm from its rivals.

The dynamic model sees on the other hand that when a firm on the free market is being rewarded persistently with above normal profits, this indicates that it has discovered a superior manner in which to please its customers over a long period of time. Far from being disobedient to market forces, the innovative firm has proved itself *exceptionally obedient*. Consumers have rewarded it – and continue to reward it – accordingly. The firm would not have 'market power' were it not granted by the consumer.

Thus the dynamic model rejects the notion that one phase of the economic process is more or less 'competitive' than any other. A genuine competitive market may be characterized by monopoly, or close competition, or any other stage in between.

In its submission at some points[18], the ACCC seems to acknowledge the above critique of the Kaysen/Turner definition. As it says, "…charging high prices or maximizing profits is consistent with competitive market behaviour". It also correctly notes that: "High prices are the market signal that attracts new entrants to markets, thereby increasing competition."

Despite these sound insights, however, the ACCC's discussion of high prices imports the biases of the Kaysen/Turner definition exposed above.

First of all, it defines 'high prices' as the 'charging of prices above a competitive level'. As we have just demonstrated, modern dynamic theories reject the implication that one stage of the market process is more genuinely 'competitive' than another. For

[17] Consider, for example the process within the widget industry. In Period 1 many firms compete, profit levels and prices are similar, and there is close substitution. In Period 2 Joe's Widgets has leaped ahead and has secured market dominance above normal profits with his Wonder Widget. In Period 3 the competitors have caught up. In Period 4 Fred's Widgets has claimed dominance through another innovation. We might say that Period 2 is better than Period 1, since consumers have all the widgets available as in Period 1 PLUS the Wonder Widget. So they have more choice. Period 3 is better for consumers than Period 2 because the price has come down on Joe's widget and its close substitutes. On the other hand, Period 4 is better than Period 3. And so on. It is clear that there is no superiority of the odd 'competition' periods over the even 'market power' periods.

[18] ACCC op. cit., p. 74

ACCC's definition, then, to have any meaning at all, we are forced to call in the assumptions of static theory.

An even more serious flaw is that the ACCC deems charging high prices to be 'undesirable from an economic welfare perspective'. But why is this so? Where has economics demonstrated that social welfare is lowered when grateful consumers, exercising their choice, reward certain entrepreneurs for their exceptional achievements? Such statements indicate the typical neo-classical failure to understand the market process as a whole and – within that process – the vital role of the entrepreneur.

We see, then, that the concept of market power, shorn of any neo-classical error, has no useful explanatory power in the analysis of economic action in a free market. 'Market power' is never anything other than consumer approval, refracted through the prism of entrepreneurial profits.

If this be true, the same critique must be levelled at 'workable competition' as defined above. If we remove the strands of neo-classical assumption that surround this definition, we can see that *any* market structure – be it a long standing monopoly charging 'high' prices, a close rivalry among many firms, or indeed any permutation in between – is the outcome of 'workable competition'. Competition is simply what happens when businesses seek to make profits in a free market.

> Competition is simply what happens when businesses seek to make profits in a free market.

The TPA does not prohibit market power as such. Nor does the TPA prohibit the acquisition of market power by 'normal commercial means'. However the TPA reflects the view that companies, unless carefully restrained, will invariably want to exploit market power in order to eliminate or 'substantially lessen' competition. S46 prohibits corporations from taking advantage of market power for this purpose.

We have seen that the definitions of 'market power' and 'workable competition' that underlie the language and application of the TPA carry with them assumptions from economic theories that are no longer broadly accepted. Recent economic work enables us to make a similar critique of the alleged deployments of market power to lessen competition.

A full catalogue of these anti-competitive strategies is not listed in the TPA. More prominent instances were enumerated by Justice Dawson in *QWI*[19]: 'exclusive dealing', 'tying arrangements', 'predatory pricing' and 'refusal to deal'. Prior to evaluating the validity of these concepts it is necessary to examine the underlying concepts of 'barriers to entry' and 'monopoly price'.

[19] *QWI v BHP* (1989) 167 CLR 177 at 50,015.

3.4 'Market Power' and 'Barriers to Entry'

The concept of a 'barrier to entry' is also essential to the task of evaluating market power. *QCMA* defined a barrier to entry in terms of 'the ease with which new firms may enter and secure a viable market'[20]. Standard neo-classical theory held that monopoly profits persist because competitors are prevented through want of some advantage from entering the market.

Like other concepts surrounding the TPA and international antitrust scholarship, the identification of a 'barrier to entry' is not uncontroversial. Many economists now see that to understand 'barriers' we need to make a distinction between the *freedom* to enter the market (available to all), and the *ability* to enter or remain in the market *profitably* (available to firms with superior and/or cheaper products).[21]

3.4.1 Legal Barriers

Freedom of entry is indeed violated when an entrepreneur with the requisite capital, labour and so on, is prevented or inhibited *by the state* from entering the market and dealing with the consumer. In this case the entrepreneur faces *legal* barriers to entry.

Ironically, the TPA itself, through its restrictions on business choice and activity, plays a prominent role in the forcible exclusion of firms from markets. The TPA is thus responsible for erecting *legal* barriers to entry throughout the Australian economy and – according to dynamic theories – substantially lessens competition.

Other explicit legal barriers sourced in the state establish monopolies in the delivery of first class mail, the collection of municipal garbage in most cities, and so on. There are also indirect legal barriers that deter entry. Burdensome compliance costs from excessive regulations, labour laws, the complex taxation regime, etc., all stifle the incentive of entrepreneurs to enter the marketplace, particularly where small businesses are concerned.

The 'beneficiaries' of such legal barriers are in the first instance the incumbent firms.[22] Legal barriers *always* interrupt the competitive process of the market and reduce social utility. Consumers are left with fewer choices. Entrepreneurs excluded from the market are left with sub-optimal alternative means of allocating scarce resources.

3.4.2 'Economic' Barriers?

Antitrust supporters downplay the importance of these legal barriers. More often, they insist, it is 'economic' barriers that prevent a firm from entering the market.

But, as Dawson, J pointed out in *QWI*, many economists now see that it is unacceptable to speak of 'economic barriers' as if there were analogues of legal

[20] QCMA, at 17,246

[21] See the discussion in G. Riesman,' Understanding Barriers to Entry': *The Free Market,* January 2002; Vol 20, No. 1

[22] This explains why many businesses and professions support legal barriers to entry.

barriers in the free market.[23] What makes a legal barrier a 'barrier' is that it forcibly *prevents or inhibits* voluntary exchanges between certain producers and consumers. In contrast, the so-called 'economic' barriers turn out on closer analysis to be situations that *result* from voluntary exchange.

For, what are these so-called barriers but significant *consumer benefits* that dominant firms provide which their competitors have trouble in matching? Antitrust theorist Dominick Armentano has highlighted the key role of consumer preference in creating 'economic' barriers.[24] If consumers preferred to have many competitors in the market instead of a concentrated or monopolistic market, it is up to them:

> "Consumers can have all the 'competitors' they want by indicating their willingness to pay higher prices that cover the higher costs of less efficient firms. That they are generally unwilling to do so is economically rational and not 'market failure'."[25]

Legal barriers, then, are the product of force and in essence anti-competitive. 'Economic' barriers are purely voluntary arrangements that are creatures of competition. Not surprisingly, these two phenomena have opposite effects on economic welfare.

'Economic' barriers are… creatures of competition.

We know from the very fact that a coercive legal barrier is operative that the *ex ante* utility of producers and consumers is lower. The consumer would have purchased a different good or the same good at a lower price but for the coercive effect of the barrier.

On the other hand, where there are no legal barriers, the fact that consumers have chosen the goods of a dominant firm reveals that their *ex ante* utility has increased. The dominant firm is dominant precisely because it has offered to the consumer goods distinguished from competitors' (actual or potential) by their higher quality or cheaper price (or both).

In sum: legal barriers give some firms unfair advantages and deprive consumers and firms of utility. So-called 'economic' barriers are advantages that are fairly acquired and manifest increased utility.

Of course, firms will often complain about unfair 'barriers' to entry when they are contemplating the difficulties involved in breaking into a market. But, in the absence of legal barriers, nothing is preventing them negotiating with consumers. Likewise, nothing is preventing the consumer from purchasing their product. We see now that what these firms are complaining of is simply their current inability to woo the consumer with a suitable product. The 'economic barrier' to a closed deal for a less efficient firm is simply that the dominant firm has a superior or cheaper product to offer.[26]

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[23] "There is, of course, vigorous debate in economic circles about what constitutes a barrier to entry into a market. There are those who would and those who would not accept that the high cost of entry constitutes a barrier." *QWI,* p.7

[24] D.T. Armentano, 'Barriers to Entry', www.mises.org Sep 20, 2000.

[25] Armentano, ibid.

[26] Sometimes the complaint is, "I've got the idea for the product, but I can't get any backing." But again this 'barrier' is reducible to consumer preferences. What inhibits venture capitalists from investing in this product is their suspicion that consumers will still prefer the benefits offered by the dominant firm's product.

There are three common situations in which the doctrine of 'economic' barriers is currently applied.

3.4.2.1 Economies of Scale 'Barriers'?

A firm may achieve an economy of scale by increasing its output and lowering costs. Obviously, this makes it harder for higher cost firms to enter and compete. But there is nothing coercive or unfair about this 'barrier'. It is merely the case of a more efficient firm dominating a market. It gives no 'extra' advantage to the dominant firm. It does not prevent more efficient firms from competing. Moreover, if the incumbent firm attempts to raise its price on the assumption that its dominance gives it some non-market leverage, then competitors will enter at the margin. And, as Armentano pointed out, if egalitarian-minded consumers prefer the market to be less dominated, they will reveal their preference by paying higher prices for the products of less cost-efficient firms.[27]

'natural monopolies' have no ability to sidestep market forces

What about 'natural monopolies'? They occur where, with the current production techniques and resources available, *the optimal size of the market is a single firm*. The situation indicates that the resources of the would-be competitor will be more effectively deployed in other, more productive ways.[28]

Many economists now argue that even 'natural monopolies' have no ability to sidestep market forces and create a 'barrier' for would-be competitors. The economy of scale has enabled the firm to set its price at a particular point which eliminates actual – but not potential – competitors. To the extent that the firm raises its price, it undoes the competitive advantage achieved by the economy of scale and, at the margin, competitors will be induced enter.

3.4.2.2 Network 'Barriers'?

Network effects are similar to economies of scale except that they refer to demand, not supply. The more consumers use a certain good (for example, software such as Microsoft Word or an online auction house) the more it increases in value. It is precisely that benefit which is the 'barrier' keeping competitors from attracting consumers to differentiated products.

As *The Economist* points out, network effects are not new: they were exploited by the Bell system in the 19th century to dominate the telephone business[29]. With the onset of information technology, the proportion of markets that are characterized by network effects compared with supply side economies of scale is increasing rapidly.[30]

But as Armentano has pointed out, even network 'barriers' are consumer sensitive:[31]

> "Consumers can always decide, for whatever reason, to reward some suppliers and exclude others. Besides, the costs of participating in any network could

[27] Armentano, op. cit.
[28] Given that technologies and consumer tastes are constantly changing, it is impossible to tell for certain whether a 'natural' monopoly exists and for how long it will last.
[29] Knowledge is Power *The Economist,* Online edition Sep 21st 2000
[30] As *The Economist* observes in connection with the information economy "…the old competition rules are no longer appropriate…breaking up monopoly could actually hurt consumers." ibid.
[31] Armentano, op. cit.

> always overcome the benefits, which would then open up opportunities for new suppliers."

3.4.2.3 Applications 'Barriers'?

When certain infrastructure goods achieve a certain level of market share the common standard that arises makes it difficult for new coming rival products to compete. In *Microsoft* Judge Jackson decided that since 70,000 new applications had been written for Windows, rival operating systems could not compete.

Armentano points out that while Windows applications deter customers from switching operating systems, there is nothing unique in this situation: *any* benefit of itself induces customer loyalty. Nevertheless firms that offer superior products to customers will overcome these loyalties. Thus, in spite of Judge Jackson's determination, millions of customers jump over Windows' allegedly formidable application 'barrier' and employ at least a dozen alternative operating systems, including Apple and Linux. [32]

> Millions of customers jump over Windows' allegedly formidable application 'barrier'.

We conclude that it is only 'legal' (state-sourced) barriers to entry that sabotage competition. The proposition that 'economic' barriers to entry exist stems from confusions about economic freedom and the market process.

3.5 'Market Power' and 'Monopoly Price'

The ability of the holder of market power to sell at higher prices by restricted output – i.e. to sell at a 'monopoly price'- assumes the existence of a 'competitive price' to which the monopoly price is contrasted.

However, many economists who subscribe to dynamic competitive theories now believe that there is no way to show how this 'competitive price' may be identified, either by the producer or by an outside observer.

For, one of the basic assumptions of economics is that: *every producer wishes to sell at a point on the demand curve expected to maximize monetary earnings.* In other words, he/she aims to sell at a point on the demand curve the range above which is elastic. Yet, if a producer decides to restrict output and raise the price in the next period, how do we tell if this is a move to a 'monopoly' price, rather than a move from a *sub-competitive* price to a *competitive* price? There is no criterion for distinguishing one move from the other. Note: restriction of output is no guide: *any* movement from a sub-competitive price to a competitive price necessarily involves as restriction of production of the relevant product.

The illusion that economists, courts and regulators are able to identify competitive pricing is fostered by the neo-classical mathematical methodology. This creates a sense of certainty not justified by the level of information available to us through the market process. Thus the neo-classical economist will illustrate monopoly pricing by

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[32] Armentano, op. cit.

drawing a demand curve and intersecting it with alternative lines of supply, creating geometrical areas and calling them (for example) 'deadweight loss'. Walter Block offers the following critique of such an exercise:

> Demand curves are not 'out there'; ready to be measured by modern econometric tools of analysis. Rather, they are, except for one dot… hypothetical alternatives which never come into play. Demand curves answer the question, Suppose that everything else in the universe were exactly the same as it now is, with the one exception that price, instead of being at P2, is at some other level; then, how much would the customer be willing to buy at that other price. In the event, the price, however, was P2 and the consumer wished to purchase Q2. That is all we know, or indeed, can know. The other points on this demand curve never come into play at all. They are contrary to fact conditionals. There is no sense in the notion that we can 'estimate' them. There is no doubt that economists can look at other instances (other times, places, people) where different quantities of this item were purchased at different prices (and even attempt to control for the fact that the prices and quantities of substitutes and complements have altered, to say nothing of changing incomes, inflation, employment and even the weather) and in that way trace out a 'demand curve.' But this has little or nothing to do with what is depicted in that diagram. The point is, a demand curve is a unique, non-repeatable hypothetical 'event'. All attempts to 'measure' it are thus doomed to failure.[33]

Another fallacy dogging the concept of monopoly price is the assumption that intersubjective comparisons of utility are possible. The ACCC makes this fallacious assumption when, after describing a situation where a merger results in monopoly pricing (higher prices and reduced output) writes:

> This outcome produces a net social cost because the losses to consumers [from the failure to trade - ICC] are larger than the increase in profits to the merged firm. This social cost is known as a deadweight loss.[34]

It is a fundamental principle of economics that parties enter into trade because they believe they will benefit. That is to say, in all trades, parties benefit *ex ante.* But economics states with equal force that when there is a failure to trade it is impossible to deduce that, had the trade taken place, the buyer's welfare would have exceed the loss to the seller. There is simply no intersubjective yardstick by which such comparisons can be made.[35] Posner admits that to conclude that there is a net social cost 'rests on the assumption that a dollar is worth the same to consumers and producers.'[36] But in the absence of any evidence, this is just wild assumption.

[33] Walter Block, Total Repeal of Antitrust Legislation: A Critique of Bork, Brozen, and Posner, *The Review of Austrian Economics* Vol 8, No. 1 (1994): p.38-39. Austrian economists are by no means alone in their critique of neo-classical demand curve analysis. Antitrust 'moderate' Bork – a Chicagoite – writes: "Passably accurate measurement of the actual situation is not even a theoretical possibility; much less is there any hope of arriving at a correct estimate…Nobody knows these curves. Even the companies involved do not. The clarity of the graphs…misleads many people." Robert Bork. *The Antitrust Paradox: A Policy at War with Itself.* New York: Basis Books, 1978, p 108.

[34] ACCC: *Submission to the Trade Practices Review 2002,* p.226.

[35] The futility of the exercise is compounded by the difficulty of counterfactual analysis, discussed above.

[36] Richard Posner, *Antitrust Law: an Economic Perspective.* Chicago: University of Chicago Press, 1976. p 256.

Professor Block also effectively critiques the notion of 'deadweight loss' as arbitrarily considering the situation from the consumer's perspective only. In reality, the unsold quantity is not only an amount the consumer desires but cannot have. It is also an amount that the producer does not wish to sell at this price. Therefore the area on the model corresponding to 'deadweight loss' is equally a 'gain' to the producer. Why view the matter from the perspective of the consumer only?

As Block shows, the reason is that there is a further assumption lurking behind anti-trust policy (equally applicable to the TPA in Australia): that the goal of competition is to enhance *consumer* welfare.[37] But this itself is arbitrary. If legislation is to aim at some sort of welfare, why should it not be *total* welfare – which includes both producer and consumer? Block continues:

> It is possible to employ a reduction ad absurdum in this regard. If we really want to enhance the welfare of consumers only, as opposed to both consumers and producers, all sorts of other enactments become justifiable which would not have been otherwise. For example, if there were any producer's surplus (economic rents earned by manufacturers) then these should be summarily seized, and handed over to consumers. Needless to say, no warrant for any such action has ever been given. [38]

We conclude that the concept of 'monopoly price' involves multiple fallacies. And our conclusion holds of course, not just for the pricing of 'monopolists' but also those of 'oligopolists' and 'cartels'. [39]

It follows *a fortiori* that establishing the existence of 'market power' by exposing monopoly pricing is impossible.

3.6 'Predatory' pricing

The ACCC suggests that predatory pricing is 'a well-recognized form of misuse of market power'. Our submission wishes briefly to set forth the case for a contrary position: that predatory pricing is another theorem based upon outmoded neo-classical modelling.

Predatory pricing is said to occur when a firm with 'market power' reduces its price from A to below a certain level B (the most profitable price for instance, or perhaps even cost [40]) in order to drive competitors from the market so that prices can then be raised to a level C so that monopoly profits can be achieved.

i. This concept rests squarely on the concept of 'monopoly price', which has been shown above to be illusory.

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[37] This potential bias needs to be carefully guarded against in Australia where the *Competition* Regulator is also the *Consumer* Protector.
[38] Block, op. cit., p. 41.
[39] For a full treatment of this conundrum, see M Rothbard, *Man, Economy and State,* Nash, 1962, pp. 604 - 615
[40] Economists even disagree on the crucial point as to what constitutes a '*predatory* price'. See Kaserman & Mayo *Government and Business: The Economics of Antitrust and Regulation.* NY, Dryden, 1995.p.128. Rothbard has demonstrated that one proposed criterion of predatory pricing as 'selling below cost' entirely misconceives the nature of 'cost'. See Rothbard, op. cit., p. 604.

Whatever its intention, not even the firm itself is able to determine that the new higher price C is a 'monopoly' price as distinct from the original price A. Certainly it is higher than B. But who is to say that at this point in time, the price is not now the competitive price anyway? In any case, let us suppose the price to be 'super competitive'. What is to stop competitors – either the old competitors or others – from entering the market to compete with the monopolist?

ii. "But won't the firm with its 'market power' be able to re-establish its sub-competitive price and ward off potential competitors and then return to the enjoyment of monopoly profits?"

Let us suppose a firm adopts this strategy. What can we conclude from it in terms of the economic welfare of the community? In fact, economics can give us no answer as to whether or not the community is worse off as a result of such a strategy.

To see why this is the case, let us analyse the process further:

In period A the firm lowers its prices and drives competitors from the market. Consumers enjoy bargain basement prices.

In period B, the firm raises its prices. Assume consumers are now facing higher prices than they would have, had not the firm adopted this strategy. The firm enjoys monopoly profits.

In period C, the firm lowers its prices again to ward of potential competitors. To the extent that it does so, the consumers are better off.

In period D, the firm, sensing the danger is over, moves its prices up again and makes more profit. Consumers are facing higher prices.[41]

…and so on.

Clearly – at least for some time – consumers have enjoyed bargain basement prices. Equally as clearly, in the period of high pricing many have 'suffered' from missing out on purchases they would have made.

Now: in order to prove that this strategy has harmed the economic welfare of the community, those who deplore it have to prove that the 'harm' caused by the period of monopolist pricing outweighs the boon to consumers.[42]

But as economics shows, it is simply impossible to make such a calculation. There is no measuring stick that we can place against the amounts of welfare or misery that stem from the strategy.

iii. As William Anderson has effectively demonstrated, the strategy, which has long been surmised in neo-classical theory, nevertheless *cannot be modelled* even by that theory itself without jettisoning basic assumptions about profit-maximizing firms.[43]

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[41] Of course even at this point, the firm will not be able to charge prices beyond what consumers are willing to pay. See 3.4.2.1

[42] We ignore here the benefits and 'losses' that relate to the firm itself.

[43] W. Anderson, *Pounding Square Pegs into Round Holes: Another Look at the Neo-Classical Theory of Predatory Pricing*, (draft manuscript viewable online at www.mises.org)

Anderson points out that neo-classical texts which on any other topic are characterized by incessant modelling invariably avoid this problem by *simply neglecting* to model predatory pricing, resorting instead to plain words or game theory. He notes:

> "…my own search to see how economists fit predatory pricing into the neo-classical models turned up nothing." [44]

Many economists now conclude that occurrences of 'predatory' pricing behaviour by firms are impossible to distinguish from the natural behaviour of every firm towards its rivals.[45] Moreover it is impossible to quantify the net effect on the welfare of society of a firm attempting a predatory pricing strategy. For either reason (and both) predatory pricing should not be proscribed.

3.7 Tying Arrangements

'Tying arrangements' have received much publicity since the *Microsoft* case. Anti-trust scholars such as Prof. D. T. Armentano[46] have long argued that tying agreements should never be illegal:

1. Tying can be a helpful way to economize on resources.
2. For sellers, tying agreements enhance goodwill with suppliers, limit free riding, and encourage distributors to invest in promotion and service.
3. For consumers, tying agreements help save search costs. Moreover, there is no reason to assume consumers injure themselves by buying tied goods. (Microsoft Explorer, the good allegedly tied illegally in *Microsoft*, was free.)
4. Whether tying agreements endure depends on whether the tied package is what consumers want. Sometimes consumers prefer to shop around and buy goods separately. In that case the tying firm fails to optimize net income and thereby discovers that the strategy has not worked. *Such knowledge cannot be gained outside the market process itself.*

3.8 Exclusive agreements

'Exclusive agreements' are also strategies that should be judged by market forces:

Companies that accept exclusive deals may wish for alternative arrangements. But the reality is that every contract freely entered into is a relinquishment of something in return for something deemed more valuable. If a company does not like the deal, it can turn it down.

Companies involved in exclusive deals do so because they believe it to be in their interest and in the interest of their consumers. They risk being wrong, in which case they will be offering customers second-best deals. But if the deal misreads the market, then the opportunity arises for competitors to enter and take away their business. *Again, the only competent 'regulator' of such strategies is the market itself.*

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[44] W. Anderson, *Pounding Square Pegs into Round Holes: Another Look at the Neo-Classical Theory of Predatory Pricing*, (draft manuscript viewable online at www.mises.org) p.12.

[45] See 3.1

[46] Interview with D T Armentano, *The Anatomy of Antitrust* The Austrian Economics Newsletter: Vol 18 No 3 Fall 1998

3.9 Refusals to Deal

'Refusals to deal' are likewise strategic attempts by companies to position themselves in the market. They are risks that may or may not come off. Companies refusing to deal risk competitors entering the market to supply the customers they snubbed. On the other hand, there are good economic reasons why a company may wish to take this risk and discriminate in supply.

Even the motive candidly expressed by BHP in *QWI* - that it simply wanted to be a sole supplier in the market for Y bars - is perfectly unexceptionable according to the dynamic model of competition.[47] BHP may well have reasoned that without market dominance, it was unable to achieve sufficient returns and would want to direct its energies to more secure or lucrative opportunities. This is the kind of weighing up of alternatives that is the essence of entrepreneurial (and indeed *human*) action.

In effect, the requirement that BHP deal with Queensland Wire at a 'competitive' price enables the plaintiff to free load on the considerable risk and outlay BHP devoted to setting up its rolling mill. [48]

Within contemporary economic analysis, serious critiques have been launched against key concepts and methodologies that underpin SS45 - 48 of the TPA.

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[47] *QWL,* Mason J & Wilson J, para. 7.

[48] The decision in *QWL* illustrates well the theoretically impossible nature of the tasks faced by the court in applying the TPA.
The court was required to ask if BHP 'took advantage' of its market power by engaging in (constructive) exclusive dealing. To answer this question, the court had to ask if BHP would have behaved in the same manner towards Queensland Wire (refusing to deal) had it been operating in a competitive market. Mason J and Wilson J concluded:

> If BHP lacked that market power - in other words, if it were operating in a competitive market - it is highly unlikely that it would stand by, without any effort to compete, and allow the appellant to secure its supply of Y-bar from a competitor.

Note what the Court is saying here: that in the hypothetically 'competitive' situation, BHP would have dealt with QWI at a reasonable price. But, surely there would be another alternative available to BHP in this situation: namely, withdraw from the market.
We might well suppose that the reason BHP decided to refuse to deal as it did was because it believed its profits in that market would have been lowered otherwise. If so, the assumption that it *would* have dealt with Queensland Wire in a competitive market cannot be made. Is it not reasonable to conjecture that profit-conscious BHP may well have *withdrawn* from a market that became competitive - or, at an earlier point, *not entered* a competitive Y bars market (or a market that would become competitive), - and invested in more profitable ventures?
One impact of this decision is that entrepreneurs in analogous positions will – to an unquantifiable extent – forgo investment projects that may become subject to similar constraints. Although this decision seems to benefit known consumers and as well as Queensland Wire in the short term, it restricts options for an unknown number of both producers and consumers in the long term. So, who can say that the benefits of the decision outweigh the future costs?
QWI thus illustrates one major pitfall of TPA – associated jurisprudence: unfalsifiable counterfactual reasoning. It also reveals how the TPA is premised on the groundless assumption that alternative welfare states can be commensurated. For a searching critique of this assumption, see M.N.Rothbard: *Toward a Reconstruction of Utility and Welfare Economics* N.Y. Center for Libertarian Studies, 1977.

3.10 Mergers

3.10.1 The Case for Mergers

At its base, the activity of mergers is simply one way in which firms act to reallocate their assets in the interests of their owners and the consumers of their products. As the ACCC states in its submission,

> "Mergers perform an important role in the efficient functioning of the economy. They allow firms to achieve efficiencies such as economies of scale and scope, synergies and risk spreading. Furthermore, they facilitate an active 'market for corporate control' in which under performing firms and managers are replaced by better ones."[49][50]

There is no way for economic analysis authoritatively to inform us as to the optimum size a firm in a given industry will be at any point in time. The information is epistemologically unavailable. It depends on technology, and the state of consumer demand in relation to factors throughout the whole economy, and so on. In the end, the role of making the decision falls with risk-taking entrepreneurs, who attempt to coordinate the resources of the firm in a way that maximizes the satisfaction of consumer demand and minimizes resource depletion. Their profits or losses in this endeavour yield the information *ex post*. It is impossible for economists or regulators to replace this vital role of the entrepreneur acting in obedience to the market.

The inability for outsiders to determine the appropriate size of firms in an industry is heightened in an economy that is undergoing rapid transformation. The increasing rate of technological change coupled with the integration of Australia's economy into the global economic system – itself rapidly evolving – makes it all but impossible to guess at the shape and size of industries a few years hence, let alone predict what optimal sizes and structures will obtain.[51]

3.10.2 A Case Against?

Many of the fallacies analysed in this submission are built into the rationale of the TPA concerning mergers law. That rationale is based on the desirability of achieving *allocative*, *productive* and *dynamic* efficiency.

1. Mergers often result in a rise in prices and, as a consequence, restriction of output is reduced. Some consumers choose not to purchase at the new price. It is alleged that *allocative* efficiency is lost as a result.

   In reply, we note that the concept of allocative efficiency incorporates the illusory notion of an identifiable 'monopoly price', discussed above. To repeat: there is no means available by which anyone, least of all any outside observer, can distinguish a shift to a 'monopoly price' from a movement from a sub-competitive

[49] ACCC submission op.cit. p.134.
[50] As noted already under 3.4.2.2, market preponderance is a precondition for network effects.
[51] We should be careful to note the global trend in many important industries towards major consolidation. To inhibit legally Australian companies' ability to mirror this trend is to impose a disadvantage on them.

price to a competitive price. Both movements are characterized by increases in price and decreases in production.[52]

2. Monopolies formed as the result of mergers are allegedly vulnerable to the loss of *productive* efficiency. Lack of incentives and competitive pressures, it is argued, may lead firms to neglect productive efficiency.

   In reply, it suffices to note that in a market where freedom of entry is not restricted (by 'legal' barriers to trade – see above) monopolies face the *threat* of competition, which has the same effect as actual competition.

3. Finally, it is suggested that market power gained as a result of mergers may inhibit the pace of innovation, or *dynamic* efficiency.

   Thus, Porter has commented:

   > "Innovation in the broad sense is driven by competition. While technological innovation is the result of a variety of factors, there is no doubt that healthy competition is an essential part. One need only review the dismal innovation record of countries lacking strong competition to be convinced of this fact."[53]

   If as is suggested there are no barriers to entry in a free market, it would seem that Porter's comments might as well apply to a monopoly facing potential competition as to firms competing in an industry. (Note the discussion below on 'national champions' and the query over the applicability of the Porter conclusions to the behaviour of genuine free market monopolies.)

Aside from arguments about economic efficiency, concerns have been expressed that mergers are in some way anti-social. It is alleged that it is best for 'economic power' to be distributed as widely throughout society as possible and that excessive market power deprives individuals of autonomy within the marketplace.

This argument trades on dubious notions of 'power'. The reality is that when market forces encourage businesses to merge and concentrate within an industry, the process is the result of consumers expressing *their* power. If consumers find the resultant goods that emerge from such a process to be inferior, they will communicate their sentiments through reduced purchases. No matter how 'powerful' a firm is at any time, on the free market it is powerless to survive in contempt of consumer wishes. So, in the end, the degree of concentration ('power') within any industry is dictated by consumer preferences communicated through the price system. 'Economic power' is, ultimately, the power of the consumer to choose or reject a good.

There is another very compelling argument against the 'power' concern. If it is undesirable to have power concentrated in a society, then how can we seriously suggest as a remedy that we remove power of isolated entities such as companies[54]

[52] See the discussion on Market Power and Monopoly Price in 3.5 above.
[53] M E Porter, Competition and Antitrust: Towards a Productivity-Based Approach to Evaluation Mergers and Joint Ventures, *Fundamental Theory Task Force Report,* American Bar Association 2001.
[54] Of course, as we have just noted, it is ultimately *consumers* that are being deprived.

and hand it back to the state, which by any standard constitutes the most concentrated nexus of power in any modern society? Yet that is precisely what happens when the power to set prices, allocate resources, and determine company size and industry concentration is placed into the hands of the ACCC and the courts under the TPA.

When advanced by 'concerned' regulators and politicians, it is difficult not to dismiss the power argument as a cynical ploy. It is even more so, when businesses themselves join the chorus. The Review should apply the sobering lessons to be learned from the U.S. experience as noted by DiLorenzo:

> "Today regulation is generally recognized as a mechanism by which special interests lobby the government to create barriers to entry or other special privileges. Research has shown, for example, that the Civil Aeronautics Board cartelized the airline industry, the Interstate Commerce Commission helped monopolize the railroad and the trucking industries, the Federal Deposit Insurance Corporation sharply limited entry into the banking business, and occupational licensing created entry barriers into hundreds of occupations. Much of the history of regulation chronicles monopoly privileges procured through the auspices of the state, as Adam Smith pointed out more than 200 years ago in *The Wealth of Nations.*" [55]

3.10.3 Eliminating 'soporific' monopolies:

A cure that worsens the disease?

In its submission, the ACCC queries the so-called Schumpeterian conjecture that firms with greater market power may have more resources and incentives to innovate. The submission relies on one study by Geroski[56], based on U.K. data relating to proportions of funds spent on R&D by firms in industries with varying concentrations[57]. Geroski claimed to have found an inverse relationship between market concentration and innovation.

Even if we cast aside the methodological problems incumbent in this kind of assessment[58] and concede the finding for the sake of argument, it is questionable

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[55] DiLorenzo, T.J. 1991 'The Antitrust Economists' Paradox' *Austrian Economics Newsletter*, 1991 (Summer): p.1.DiLorenzo's comments are consistent with those of Nobel laureate Chigagoite George Stigler: "The declining support for antitrust policy has been due to the often objectionable uses to which that policy has been put. The Robinson-Patman Act, ostensibly designed to prevent price discrimination (that is, companies charging different prices to different buyers for the same good) has often been used to limit rivalry instead of increase it. Antitrust laws have prevented many useful mergers, especially vertical ones…A favourite tool of legal buccaneers is the private antitrust suit in which successful plaintiffs are awarded triple damages." G Stigler, 'Monopoly'

[56] P.A.Geroski, Innovation, Technological Opportunity, and Market Structure, *Oxford Economic Papers* 42, 1990, pp.586 - 602.

[57] The submission also quotes from research of Professor Michael Porter, but the quotation is not relevant. Porter was not referring to countries *free market* monopolies operated, but where governments artificially created concentrations by stifling competition. M E Porter, Competition and Antitrust: Towards a Productivity-Based Approach to Evaluation Mergers and Joint Ventures, *Fundamental Theory Task Force Report,* American Bar Association 2001.

[58] Notions such as 'market definition' and indices of 'innovation' are matters of great dispute among economists. Some economists will argue that given a long enough run, the 'market size' is in fact the whole world for every entrepreneur. See Block, *op.* cit. p. 52.

whether the study proves anything worthwhile about the effect of concentration on dynamic efficiency *across a whole economy*.

Thus, conceding that concentrated firms may become 'soporific' about innovation once they reach a certain level of market dominance, the next relevant question surely is: what would be the impact of forcibly eliminating mergers and concentrations?

For, the Geroski finding can be interpreted thus: firms, anxious to achieve market dominance strive to innovate to get ahead of their rivals. When they achieve dominance, they devote their energies elsewhere.

The implication of this for suppression of the 'carrot' of market dominance is surely obvious: Lower the value of the prize by eliminating market dominance, and the propensity for firms through to innovate in the quest for that prize will drop off accordingly.

Thus the relevant, but *unanswerable* question not raised by the ACCC is: what is the *net* effect on innovation of the elimination of market concentrations?

3.10.4 The 'National Champion': a straw man?

It would seem fairly common sense that in a small economy such as Australia's, mergers ought to be permitted according to market forces – even to the extent of allowing monopolization to occur. Apart from anything else, such mergers may well be necessary to achieve economies of scale, and facilitate greater competitiveness on the international market.

In its submission the ACCC attempts to undermine this particular argument for the value of mergers.

The topic is referred to as the debate over 'national champions'. This is an unfortunate use of terminology as it has led to confusion between two distinct (indeed mutually exclusive) theses.

One thesis stems from a once positive evaluation of the post-war Japanese economy. It stated that governments ought to follow the lead of Japan and actively encourage concentrations, cartels and even monopolies in certain sectors in order to maximize competitiveness in the international market. Although at one time a popular theory among pro-interventionist economists, this view has by and large been discarded in the light of the recent history of the Japanese economy.

The second thesis is that if a monopoly or highly concentrated sector obtains as a result of genuine market rivalry, then it represents the optimum allocation of resources at that particular moment in the economy and should not be seen as an example of 'market failure'.

It should be clear that, from an economic point of view, a state-orchestrated and subsidized national champion is an entirely different entity to a monopoly that establishes and maintains its 'dominance' by being supremely successful at catering to the wishes of the consumer.

In its submission to this inquiry, the ACCC offers two arguments against 'National Champions.' Both are flawed.

1. The business community (61%) is opposed to the emergence of 'national champions'.

Reply: This outcome is to be expected, since individual businesses will be concerned about their own particular fate. *Ex hypothesi*, the number of businesses who would emerge as 'national champions' is substantially less than the number of businesses such a process would eradicate from the market. So it is perfectly rational from the point of view of self-interest for a greater number of businesses to oppose such a policy than to support it.

But the 'argument' simply begs the question: can economic reasoning justify a 'national champions' policy? Good competition law should account for the welfare of the whole economy, not the fate or subjective wishes of individual businesses.

2. Academic studies have empirically demonstrated the undesirability of 'national champions'.

Reply: It is clear from this argument that the ACCC is unable to grasp the distinction between monopolies that arise through the anti-market processes of state fiat and support, and monopolies that arise through genuine rivalry on the free market. The only empirical studies cited in the ACCC submission concern *government-orchestrated* monopolies, *not* free market monopolies. However rigorous and valid these studies may be for other purposes, this Review should ignore them.

Note, for example, Professor Michael Porter's cited conclusions against 'national champions':

> "We found…few 'national champions,' or firms with virtually unrivalled domestic positions, that were internationally competitive. Instead, most were uncompetitive *though often heavily subsidized and protected*."
>
> "Contrary to some popular views, our results suggest that Japanese competitiveness is associated with home market competition, not collusion, cartels or *government intervention that stabilizes it*."[59]

But of course, what has to be proved for the purposes of the ACCC's argument is that monopolies or large firms that emerge *purely as a result of market forces – that is, unsubsidized and unprotected* – were uncompetitive.

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[59]Sakariko, M & M E Porter, 'Competing at Home to Win Abroad: Evidence from the Japanese Industry', *Fundamental Theory Task Force Report,* American Bar Association 2001.

Anyone familiar with the history of state-orchestrated concentration and cartelization which has characterized the Japanese economy over the last century will recognize the inapplicability of Porter's conclusions to the issue at hand; namely, whether *free market* monopolies will display the same lack of competitiveness as Japanese featherbedded monopolies and cartels.

Wittingly or not, ACCC has knocked over a straw man.

- **Typical arguments concerning the detrimental effects of mergers draw from irrelevant empirical studies.**
- **According to many economists, there are sound economic reasons for mergers on the free market.**
- **The arguments that specific mergers can be shown to 'lessen competition' or otherwise lower economic welfare depend on highly disputable methods of assessment.**
- **The presumption should be that all market-produced mergers are competitive strategies, which enhance economic welfare.**

3.11 Cartels

3.11.1 Cartels and Cartelophobia.

If the above analysis of alleged 'anti-competitive' behaviour is valid, there can be little foundation to the cartelophobia that has so deeply taken hold at a popular level both in Australia and abroad.

And indeed, the vehemence with which 'hard-core' cartel behaviour is denounced is rarely if ever backed up with falsifiable theory or solid empirical analysis. It seems that the very mention of the word 'cartel' has a detrimental effect on the thinking processes of pundits who are otherwise anxious to portray themselves as coolheaded, rational analysts of economic phenomena.[60]

The ACCC submission to this Review is a relevant case of cartelophobia and the woolly – if not dangerous – thinking it engenders.

3.11.2 Cartelization as 'theft'?

For example, it commences its discussion by unambiguously denouncing cartel behaviour as 'morally reprehensible', 'abhorrent', 'a form of theft', 'comparable to fraud' which accordingly should be criminalized. These terms are then intoned antiphonally through the remainder of the discussion, lest the Review committee somehow lose sight of the monstrous evil it must curb.

[60] If we may be permitted one sarcasm, this is about the only detrimental effect for which a free market cartel has ever been definitively proved to have been responsible.

But then, incredibly, the ACCC submits that only *large corporations* be liable to criminalization for cartel behaviour! The ACCC reasons that only large companies are in a position to do the most damage through this allegedly reprehensible behaviour.

One needs to ask the ACCC (which is of course not alone in making this proposition): since when did the criminal law excuse a person from theft (or any other crime) because they failed a wealth test? Does not natural justice require the criminal law to have strict regard to the nature and gravity of the deed, not any accidental feature of the perpetrator such as wealth, background, ethnic origin…?

The rationale that only "large corporations with a significant market presence [should be criminalized, since they] will usually have the most harmful economic impact"[61]are in a position to inflict substantial harm by this means, would introduce a sinister precedent into the criminal law.

There are other anomalies and inconsistencies in the ACCC proposition that cartelization is a form of theft.

For example, the ACCC concedes that, although highly unlikely, that there may be occasions when hard-core cartel conduct produces a net public benefit and should be authorized.[62] The ACCC needs to argue more persuasively this rather astonishing proposition – that a type of *theft* could produce net public benefits.

Again, the ACCC rejects making intention to substantially lessen competition an element of the offence, as overseas experience (Canadian) has proved that this element is difficult for the prosecution to satisfy. This would make cartelization unique in the genus of theft crimes: the *mens rea* for the crime does not include the intention to bring about the alleged evil itself!

The difficulties encountered by the ACCC in categorizing cartelization consistently as a form of theft should give notice that the categorization is erroneous.

Further indirect evidence that this is the case can be garnered from the comments of Justice Finkelstein in the *Transformers* case (cited in the ACCC submission):

> "Generally the corporate agent is a top executive, who has an unblemished reputation, and in all other respects is a pillar of the community. These people often do not see antitrust violations as law breaking, and certainly not conduct that involves turpitude…"[63]

Both the ACCC and Finkelstein J. overlook one obvious explanation for this situation: pillars of the community may reject the notion that cartelization is shameful *simply because they can see that it is not*.

[61] ACCC submission, op.cit., p.41.
[62] ibid., p.49.
[63] ACCC v ABB Transmission and Distribution Limited (No. 2) [2002] FCA 559, at para. 28.

3.11.3 Economic Objections to Cartels

Many of the criticisms of cartel behaviour (for example, price fixing) have been dealt with in earlier sections or are can be refuted along similar principles. They will not be repeated here. Suffice it to say that the perceived evils of cartel behaviour are invariably based on highly debatable or outdated concepts.

The ACCC submission cites estimates from the OECD and other sources on the numbers of cartel convictions and amounts of money involved. For example, six drug companies are alleged to have colluded in a manner that 'cost' the UK National Health Service up to AU$1.08 billion.

However, these figures mean nothing if the notions on which they are based – namely monopoly and predatory pricing – are themselves suspect.

As shown above in the discussion on monopoly pricing, such statements are, according to many economists, meaningless. If the profitability of the six companies increased by moving to that Price x Quantity point on the demand curve and restricting production accordingly there is simply no way of proving that this was not a move from a sub-competitive price to a competitive price. All that could be proved is that the undeniable fact that, *ceteris paribus*, the NHS would have not had to spend AU$1.08 billion had the price remained where it was. But if this is a 'loss' or 'theft', then so is every attempt to find a competitive price by moving up the demand curve.

3.11.4 The Economic Role of Free Market Cartels:

The Review committee should consider alongside the alarmist claims of the ACCC (and others) a more favourable view of cartels that is gaining adherence and is consonant with other developments in monopoly and competition theory.

For example, Professor Pascal Salin has demonstrated that, far from being creatures bordering on the demonic, cartels that form on the free market are entities that have a positive role to play in meeting certain specific market demands.[64]

Sometimes cartels form purely with a view to maximizing profits by coordinating pricing and production plans. On these occasions, as Rothbard has shown, the cartel is inherently unstable in the free market, where (as has been shown above) there are no barriers to entry[65]. The larger the profit, the greater the incentive for newcomers to enter the market and offer similar substitute products at competitive prices. Cartel members, bound by quota agreements, will grow increasingly frustrated at watching non-cartel competitors expand and take away sales. In addition, the more efficient firms will grow restive with the agreement that in effect shelters their less efficient competitors. The efficient producers will tend to be the first to leave the cartel, precipitating its demise. Finally, if joint action is the most efficient and profitable course for all members, there will be a tendency for the cartel to merge into one firm, thereby reaping the advantages of simpler decision-making processes. Thus this type

[64] Pascal Salin, 'Cartels as Efficient Productive Structures,' *The Review of Austrian Economics* Vol.9 No.2 pp. 29 - 42.
[65] Rothbard, op. cit., p 572.

of cartel will tend to disband from both internal and external pressures and prove a transition phase between a monopoly and a market of several (or many) competitors.

However, Salin has shown that not all cartels are formed with a view to coordinating production and pricing and thereby maximizing profits.

Just as competition normally induces producers to differentiate their products from one another, cartels are voluntary structures that allow producers to suppress product differentiation. When they do so, cartels are acting on the belief that in this case, the undeniable benefits of product differentiation are superseded by the benefit of homogenization, which introduces a higher degree of substitutability between products. Salin lists exemplary activities: telecommunications, transportation, money production, and so on. Speaking of money, for example, Salin notes:

> "…anyone may accept the idea that it would not be *optimal* to have a very large number of different currencies."[66]

But why, then, should firms in such industries merge and form monopolies? Why, in other words the need for cartels as such?

In the first place, monopolies are not the only solution, as cartels can be as efficient as monopolies in these particular markets. And secondly, we cannot know *a priori* whether the advantage of homogenization exists, to what extent it exists, and for how long. It has to be discovered (on an ongoing basis) by the players in the market themselves.

In this situation, cartels may have some advantages over a single producer. Within a cartel, with its multiple centres of decision-making, there remains the possibility of future (and relatively rapid) diversification. The cartel, which here and now finds advantages in co-ordinated production, can readily disband when other productive structures present themselves as more efficient.

Moreover a cartel avoids certain diseconomies of scale that attend large monolithic organizations, thereby minimizing institutional costs.

Pascal effectively concludes that as an intermediate productive structure between monopolies and multiple competing firms, the cartel enjoys the best of both worlds in that it provides in certain situations an optimal combination of coordination and cooperation. In his thesis, Pascal incorporates the insights of Ronald Coase in his seminal work on the firm. According to Coase's theorem, firms that succeed on the market do so by arriving at the optimal mix of spontaneous and constrained actions: the cartel is merely one further way in which that optimal mix is organized.

The Review committee should note the widely diverging views on the role of free market cartels, and the provenance of those views.

Negative, moralistic judgements of cartel behaviour stem from outdated models of perfect competition. More dynamic models of competition see a positive role for cartels within the market economy.

It is surely inappropriate to consider criminalizing cartel behaviour when the economic model that condemns it is itself losing credibility.

[66] Salin, op. cit., p. 36.

4. TPA, Part IV: Proposals For Legislative Reform

ICC submits that, in the light of the above analysis, it is doubtful that many of the conceptual assumptions surrounding the TPA and its application enjoy a sufficient level of acceptance within contemporary economics so as to form the basis of good law. Although Part IV was enacted in the belief that the protection and encouragement of economic 'competition' was of benefit to social welfare, many economists now question whether the enforcement of its provisions do anything other than stifle legitimate and beneficial forms of economic activity.

ICC is not arguing that a new broad consensus has emerged on specific issues such as particular 'anti-competitive' practices. It concedes that many economists can be found who would disagree with part or all of the substantive pro-market critique outlined above.

Nevertheless even economists less favourable to the operation of the unhampered market reluctantly agree that within their discipline much of the old orthodoxy has been swept aside. It would be churlish of them to insist that the TPA remain fixed in its substantive restrictions on business activity, much less introduce further restrictions, when the theoretical underpinning of those restrictions is so open to dispute.

Accordingly, the time has come to consider a radical redrafting of the Act that reflects the substantial shift over the past two decades from the post-war doctrines concerning the market and 'anti-competitive' practices.

4.1 ICC Recommends a Substantial Redraft of Part IV

ICC's recommendation is that Part IV of the TPA be redrafted according to the following principles:

1. There is a broad consensus of economic thought that the market economy in principle promotes economic well-being. In addition, there is considerable and growing scepticism as to the definition of and harm wrought by, 'anti-competitive' acts proscribed under Part IV.

   ICC's recommendation is that Part IV of the TPA be redrafted to provide a *legal* presumption that all business practices in a free market (*including* 'hard core' cartel behaviour, mergers and all others currently proscribed under Part IV) are competitive in nature, do *not* damage overall community welfare – and indeed will even be expected to produce net economic benefit to the community – and are therefore permissible.

2. The plaintiff must rebut this presumption by proving demonstratively that in the case in question a company's action(s) is anti-competitive according to a respectable definition, *and* that it is of substantial harm to net community welfare.

3. Rebuttal of the plaintiff's case should consist in demonstrating that the practice is not 'anti-competitive' under the plaintiff's or an alternative respectable definition, or – conceding the anti-competitive nature of the behaviour – defeating the plaintiff's case that the practice is of substantial harm to net community welfare.

The rationale for this proposal is that it accords with principles of natural justice and takes into account the fundamental shifts that have occurred within the discipline of economics.

The Western liberal tradition is marked by its concern to proscribe only those activities which are either intrinsically unjust or can be demonstrated to lessen the common good significantly. This concern is reflected in the history of the common law that enshrines the presumption of innocence. The onus is on the plaintiff to show that the defendant is legally liable.

These two principles should serve as guides in considering which acts to proscribe through legislation.

Accordingly it is difficult to see how the law could forbid certain forms of economic activity when respectable and widely supported schools of economic thought view those same activities as either neutral in effect, or even positively beneficial to economic welfare.

Specifically, it seems grossly unfair that a court, by adopting the theory of one recognized school of thought, could rule on the balance of probabilities against a defendant, when a plausible critique of that school's conclusions could be supplied by the defendant. Such a situation is the epitome of trial by opinion, not fact.

These principles enumerated above, if incorporated into the Act, would substantially assist in the removal of such injustices.

4.2 ICC's Response to Recommendations from other organizations.

In relation to recommendations of other submissions that have been published to date, ICC draws the following conclusions:

- The recommendations for the criminalization of 'hard core' cartel behaviour – even apart from legal anomalies discussed above – manifest a remarkable ignorance of significant work in economics questioning the validity of old-fashioned monopoly theory.

  ICC points out that the standard of proof for the finding of fact in criminal law is 'beyond reasonable doubt'. This standard should serve as something of a guide when considering the criminalizing of certain actions. Given the pluralistic condition of contemporary economic thought, it simply could not be held as 'beyond reasonable doubt' amongst a sufficient consensus of economists that 'hard core' cartel behaviour damages economic welfare to any significant degree.

On both legal and economic grounds, ICC Australia rejects the criminalization of 'hard core' cartel activity.

- Likewise, the strengthening of provisions by the addition of 'effects' tests as alternatives to 'purpose' tests is to be rejected.[67]

- The Review Committee must reject arguments for the maintenance of more interventionary options that are placed before it in place of proposals for less interventionary measures: for example, maintenance of the 'substantial lessening of competition' test over the former, higher standard 'dominance' test.

ICC insists that there is no justification in economic theory for the *strengthening* of the provisions of the Act by the addition of an effects test for S46. Likewise, ICC believes that proposals to soften provisions of the Act – for example the revival of the 'dominance' test are movements in a direction consistent with developments in economic thought.

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[67] Proposed, for example, by the ACCC in regard to s46.

5. About ICC and the author

ICC Australia is the Australian affiliate of the International Chamber of Commerce, the world business organization. ICC is the biggest business association in the world, serving thousands of member businesses in 140 countries. Of all the contributors to the TPA Review, we can claim the broadest constituency, representing as we do businesses of every size and from every sector. ICC seeks every opportunity of advancing our members' interests by speaking out on issues that impact on international business, or Australia's international competitiveness. The TPA Review qualifies on both counts. We recognize the obvious relationship between economic freedom and prosperity; we seek to promote market freedom, and restrain the perennial tendency of governments to derange the balance and harmony of markets by legislative and regulatory interference, frequently at the expense of liberty and prosperity.

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