Property Rights and Competition Policy

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Summary

Economic well-being is created and sustained by firmly respected individual property rights and competition between producers. While the benefits of competition are well understood, it is property rights that are the bedrock of this process and their protection should normally receive the priority where there is conflict.

This paper examines contemporary Australian approaches where there is an apparent conflict. It concludes that policy is too ready to sacrifice property rights to ensure continued competition. This applies both to the treatment of "essential facilities" in infrastructure and to mergers. The sacrifice by regulators is often incorrect because it is premised on a static view of competition rather than in the more dynamic framework of contestability.

This aside, greater caution in regulating the use of individual property is necessary. Regulatory intervention reduces incentives to risk-taking and innovation. There should be a reduction in the scope for regulatory intervention both for governments themselves and for their regulatory agencies.

Property Rights and the Economic Growth Process

The conditions that led to England and other parts of Europe suddenly increasing their income levels from the end of the seventeenth century have rightly occupied great attention among economic historians.

There has been much analysis of its causes–the Protestant Ethic, climatic conditions and the overthrow of feudalism have all been cited. Many of these aspects had an importance but the overwhelming cause, painstakingly documented by Tom Bethell[1] was the security over property rights that the English and, to a lesser extent, other Europeans enjoyed. Secure property rights allow basic human goals to be pursued by allowing those who are successful, frugal or hard working to enjoy the benefits without having to share them.

The roots of the security of property predate John Locke, whose writings described the highly unusual legal restraints on the political power of English kings and nobles. Henry Bracton, a judge in the fifteenth century wrote, uncontroversialy, "the king must not be subject to any man but to God and the law." And added "for there is no king where will and not law bears rule".

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[1] Bethell, Tom, *The Noblest Triumph*, St Martin's Press, New York, 1998.

The beneficial effects of legal restraints on a political ruler remind one of of the "Mad Max" film where Tina Turner had established herself as the potentate of a primitive island of brutal civilisation. She was obliged to allow Mel Gibson to go free after he prevailed in mortal combat because the Law required it. Perhaps the scriptwriters were unaware, but they had happened on the circumstances where commerce could take place, namely the rule of law rather than, as is the case in dictatorships, the rule by law that upholds the interests of the ruler rather than of all.

The English Civil War marked the attempt by the Stuart kings to assert power over property which the common law had defined gradually since the thirteenth century. The issue remained open until the Glorious Revolution of 1688 finally confirmed Locke's views on the sanctity of private property from royal takings. And it was only after 1688 that Locke's work was published under his own name in England. (Prior to then, in a version of the present day phone tap, Locke's dining hall conversations were monitored by government lip-readers).

Although property rights had been generally accepted elsewhere in Europe, in England the security was greater and more extensive since it also included tenants' rights. One nation with similar property rights was Holland, which however was an early victim of loss of competitiveness to England. The Dutch were unable to run their empire as frugally as England and the average level of taxation was three times that of England.

The early economists talked little of property rights as a means of generating wealth, largely because those rights were so entrenched that they were taken for granted. The first of Smith's *Lectures on Jurisprudence* (1760 but not published until 1978) stated "the first and chief design of every system of government is to maintain justice: to prevent members of society encroaching on each others' property, or seizing what is not their own." *The Wealth of Nations* itself was more concerned with the division of labour and free trade. Jean-Baptiste Say, writing in 1803, probably spoke for the whole profession when he wrote that only with secure property rights "can the sources of production …attain their utmost degree of fecundity", a truth he regarded as "so completely self-evident that demonstration is quite superfluous." (p. 98)

In this, he was echoing something long familiar to the ancient philosophers. Aristotle noted that

> What is common to the greatest number gets the least amount of care. Men pay most attention to what is their own: they care less for what is common. (Politics, Book II, Chap 3.)

From the middle of the nineteenth century until quite recently, economists have tended to regard property rights as secondary. Of course Marx was the great example but even within the mainstream, they came to a view that property ownership was irrelevant. JS Mill described the distribution of property as of little material importance in the economic growth process. Marshall, his heir to leadership of the profession, codified marginal analysis and hoped that individual property would be less important in the future. And the founders of the American Economic Association

in 1885 wished to create a society that would build a theory to assist in the development of the new more moral world that they foresaw.

Communist states were one upshot of this new moral world. While as early as 1944, Hayek had predicted the economic decline and loss of liberty that would follow from socialism, he was a footnote to most of the profession.

The ultimate verdict on the impossibility of economic prosperity without secure, individually owned property rights had to await the fall of the Berlin Wall ten years ago and its immediate aftermath.

In the meantime, the study of law and economics at the University of Chicago under Coase, Stigler, Posner and Alchian was restoring the importance of property rights to economic analysis.

The central theme of the Coase theorem was that, with trade, externalities could be internalised by re-assigning rights. This would allow efficient solutions. But the solution was pregnant with even greater interventions–the government would re-arrange property rights so that the most efficient party was granted them. In fact, in the past, common law judges had not determined cases on the basis of efficiency, which was Posner's extension of the Coase Theorem, but on the basis of making property more secure more easily tradable and encouraging competition. It was the incidental effect of this that has enhanced economic efficiency.

While the failure of the centrally planned socialist economies demonstrated the importance of property rights and the rule of law at the economy-wide level, the success of privatisation demonstrates the potency of individual property rights at the level of the individual firm. The study of some 1370 firm-years by Dewenter and Malatesta[2] shows that firms, once privatised, have a superior return on assets (actually over twice the return). In addition, the data shows that returns on assets and equity increased more rapidly for firms that were privatised than had been found in the period prior to privatisation.

This latter finding is important because governments normally take energetic steps to improve the management of state-owned firms prior to privatisation. In doing so, they will have already implemented of the most easily won improvements.

Competition and Regulation

Promoting Competition and Assaulting Regulation

The potency of competition has long been a, and probably the, dominant tenet of economics. The Smithian values turned on free trade in what was then a major idealogical dispute with the mercantalists.

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[2] Dewenter K.L., and Malatesta P.H., *State-Owned and Privately-Owned Firms: An Empirical Analysis of Profitability, Leverage and Labor Intensity*, March 1999, School of Business Administration, University of Washington Seattle. This is an update of *Public Offerings of State Owned and Privately-Owned Enterprises*, Journal of Finance, 43 Feb 1997, p 275-298.

It goes without saying that the debate was never completely won. The world shifted from a free trade area to one of autarky after 1914 and saw a considerable reduction in living standards. We should not assume the inevitability of the advances in free trade we have enjoyed since 1945 will continue.

Free trade was one aspect of commerce that England in its internal market enjoyed over most of continental Europe. But allowing competition to bring increased income requires more than free trade.

Trade impositions are only a sub-set of the regulatory restraints that can stifle the economic growth process. Here again, the experience of the English economic take-off is useful. The 200 years to the 1870's marked a systematic culling of laws and regulations. Of the 18,110 Acts passed since the Thirteenth Century, over four-fifths were repealed. The great majority of the repealed acts were contraints on competition.

Building upon a reform perspective that dates back to the early years of the Hawke Government, Australian Governments have sought to reduce regulatory impediments to the efficient operations of business. Prime Minister Hawke, addressing the Business Council of Australia in September 1984, said:

> I am convinced that after eighty-four years of federation, we have accumulated an excessive and often irrelevant and obstructive body of laws and regulations. We will examine critically the whole range of business regulation, most importantly with a view to assessing its contribution to long term growth performance. We will maintain regulation which upon careful analysis, clearly promotes economic efficiency, or which is clearly an effective means of achieving more equitable income distribution. And we will abandon regulation which fails these tests.

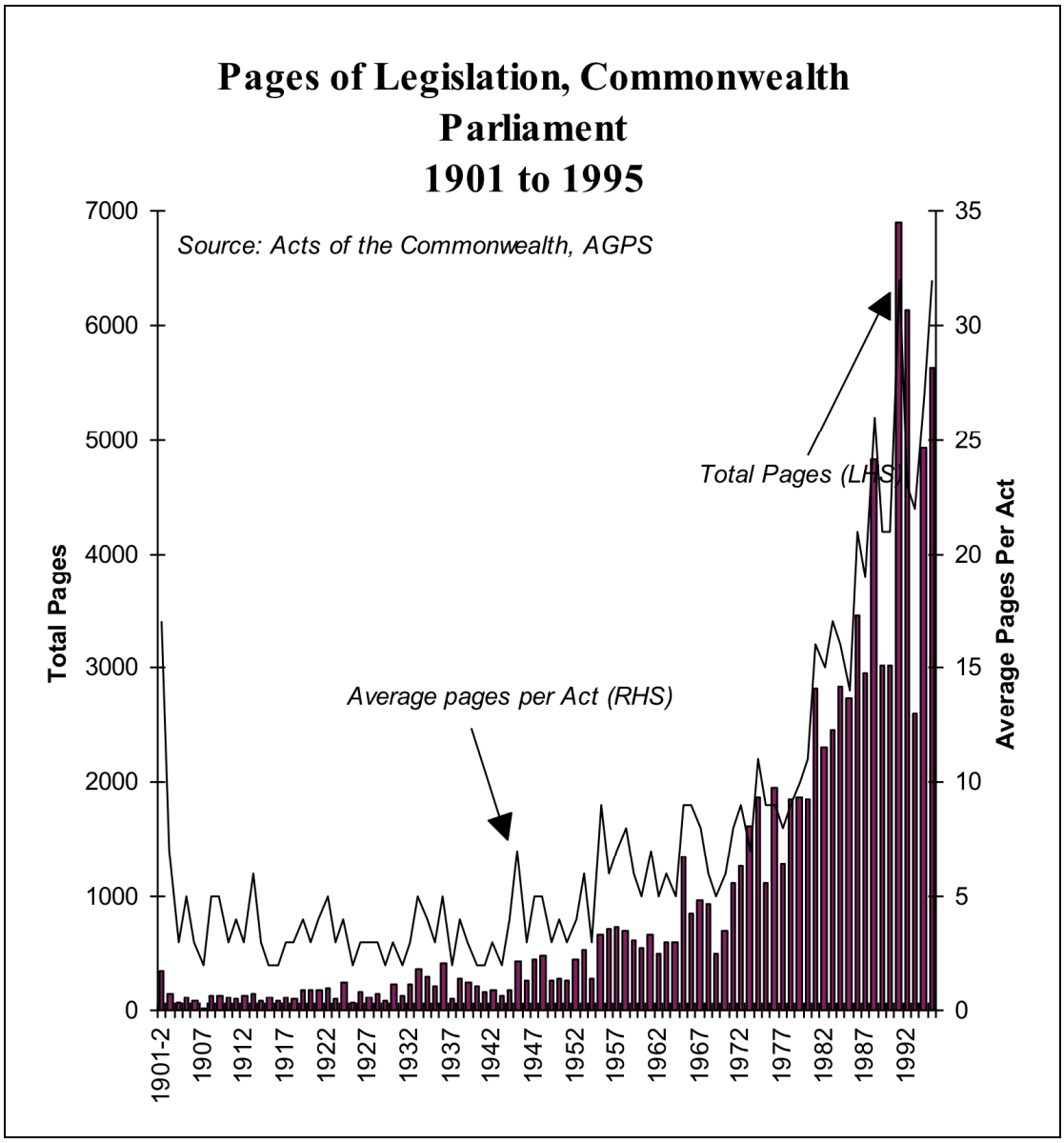
This offered a clear signal favouring deregulation---perhaps the clearest such signal previously given by an incumbent Government in Australia. But it was tempered by an agnostic view that some regulation promotes economic efficiency and that some regulation may be a justifiable means to the promotion of equity in income distribution.

Following the Hawke initiative, regulation review units were set up in the Commonwealth and most States with a view of arresting and reducing the plethora of regulatory barriers to the supplier/consumer interface. Insufficient powers and resources were given for these regulation review watchdogs to have a major impact. But the initiative marked a change in attitude of government intervention in the economy. Previously government leaders had largely taken the view that their actions were unambiguous in bringing benefits. The initiative recognised that the sand thrown in the wheels of commerce by governments was itself often the problem.

In this respect, the Hawke initiative echoed, albeit palely, the reforms that underpinned the economic take-off that we call the (English) industrial revolution.

In Australia, most areas of direct intervention of governments in business decisions have been much reduced over recent years. Social regulation over standards, pollution and the like has tended to mount but the regulation of businesses through

tariffs and subsidies, and directions to offer services, has been much reduced. The net position has been little change in the explosive growth in regulation, which is illustrated in the chart below.



Regulation to Promote Competition

There are two areas where regulation has been increased with the goal of promoting increased competition. One is access to monopoly services. The other is regulation to control mergers of firms where this may bring diminished numbers of rivals.

Since stable property rights and competition are the twin engines of prosperity, is there a role for government to intervene to promote competition? If such a role exists, it is necessary to:

- examine where there might be a conflict between the exercise of private property rights and the assurances of workable competition;

- determine, if such a conflict occurs, the criteria for overriding property rights; and

- establish institutional arrangements that generate the minimum of waste and paperburden costs in addressing the issue.

While competition undoubtedly generates increased efficiency, will government intervention select the appropriate competitive model? And will it lead to the diversion of entrepreneurial energies into avenues that are unproductive?

The Control of Natural Monopolies or Essential Facilities

The notion of essential facilities is both elusive and subject to change. In the US, the regulatory authorities have ceased controlling AT&T as it has become clear that there is ample competition in what was once thought to be an archetypal 'essential facility'. By contrast, in Australia the ACCC is requiring Telstra to offer access to its network on terms it does not favour.

The most entrenched monopolies–perhaps the only ones with durability–are those supported by government. The central purpose of the Australian competition reforms was to smash these. In part, this meant hiving off the clearly contestable areas (e.g. generation of electricity). What is left is a set of residual apparent monopolies covering wires, pipes, ports and roads. Most of the recent policy debate has focused on the price and access conditions.

With perfect knowledge, the wise and incorruptible bureaucrat could devise a transmission system that would prevent monopolistic waste and could also bring about a great many of the dynamic gains achieved with commercial rivalry. However, these conditions are not present. Producers and carriers will be reluctant to reveal to competitors and customers alike the extent of their costs; and they too have imperfect knowledge of these. Buyers will seek to keep options open to the maximum degree, and will not reveal the full extent of their demand, their alternative means of having it supplied and their preferred means of supply.

While government should, in the interests of economic efficiency, insist on certain access rules for its <u>own</u> facilities, it must be careful not to impose these on private facilities that are already in existence and that were built under different contractual arrangements. Government seized monopoly powers when it built or nationalised its own facilities, but private firms often built them without a monopoly. And if a private firm took risk and placed itself in a situation of commanding some market power because of its success, to penalize it by denying it the ability to profit from this will deter other such entrepreneurial activity.

In this respect please allow me the indulgence to quote from a paper I wrote for EPAC some years ago before the importance of property rights had assumed the mini-revival we have seen over the past few years. In that paper[3] I argued,

> *…all business decisions are based on the prospect of obtaining a residual income from the capital, labour and other inputs that comprise the goods and services that are sold. The lure of these rewards is the energy source for economic efficiency. Unless totally unexpected and not envisaged to be repeated, measures that bring the attenuation of these high profits diminish the pursuit of promising but risky opportunities. This diminution is to the detriment of economic flexibility and efficiency.*

It is from fears of the deterrent power that requiring open access might entail that the "Efficient Components Rule" was devised. This gives firms forced to open their networks to competitors the profits they thereby forego. That particular rule is not much loved by regulators and planners and its use may be specifically precluded by the Competition Policy Reform Act. But as a specification of "fairness", it has far greater merit than a regulator determining a price based on a reasonable return for a business.

Requiring private firms to provide access to competitors or others will diminish their incentive to build a facility or will distort the nature of that facility if built. Well-established property rights are, however, consistent with open access at a commercial price. For example, it is generally agreed that patents which assign ownership to ideas and products encourage innovation for the benefit of all. Access of such ideas and products can then be arranged under mutually accepted licensing agreements.

The *requirement* for open access to these facilities might have perverse effects both on the competitive process itself and on economic efficiency. Some entrepreneurs will want to have greater control of the sources of supply and the throughput of the facility than would be permitted under open access. Either they would build a sub-optimal facility so that only their own booked capacity is transmitted, or they may be discouraged from building any facility, with consequent loss of additional supply to the market.

Even when the private owner had been granted a monopoly by the Government it should not be lightly taken away. Where a government has created a property right through mandating a shortage the excess profit is often capitalised and sold. Sound government, even in cases like taxi plates where the monopoly right is clearly a contrived one, should compensate the monopoly owners if it wishes to disturb their monopoly in totally unpredictable ways.

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[3] Moran A., *Property Rights and Efficiency: Ownership of Innovations and Mineral Prospects*, in Issues in the Pricing and Management of Natural Resources, Background Paper No. 16, Economic Planning Advisory Council, 1991.

Using Competition to Bring About Optimal Access Conditions

The Hilmer recommendations[4] rightly focus upon the importance of competition in bringing about a more efficient and productive economy. Government should do everything possible to prevent its own agencies and institutions from inhibiting this process. This means abandoning exploitative monopolies in the form of utilities and outlawing procedures that create barriers to commercial entrants or prevent the full force of competition.

The codes covering access and pricing to gas and electricity networks presume these are monopolies. Yet recent events have demonstrated the potential for active competition in this area of supply. Even with electricity, in Victoria rival distributors are planning to drive new lines into each others' territory. Further evidence of the potential is observable in the skill that AGL has shown over many years in setting its NSW pipeline charges at a level that allows it to profitably ward off rival facilities. AGL has responded to competitive threats by reducing prices in areas where those threats have greatest potential.

The nightmare for a utility business is that if it adopts too hard-nosed an approach to pricing and service, it will invite competition and leave the existing asset "stranded". Fear of having "stranded" assets means that little by-pass is likely to eventuate. But the control over excess prices that competition brings does not require that a competitor physically emerges. Contestability for the market is quite adequate. Following Baumol, Panzar and Willig's work[5], this notion of contestability has extended the realm within which regulation can be safely excluded. The ability of a rival to take all the market from an incumbent is reason enough for the latter to behave as though competition was actually present.

Competition or contestability is much superior to regulation. Indeed, the regulator's role is to make judgements that, in his view, correspond to those that would emerge in a competitive market. The problem with a regulated price is that it is likely to bring distortions. If set too high, and the facility is indeed a monopoly, excessive prices will shift customers towards activities and expenditures that offer less value than would be the case with market determined prices. Of course, if the facility is not a genuine monopoly, prices set too high are irrelevant because competition will force them down to market determined levels. If prices are set too low, competition will be pre-empted and the facility owner will have inadequate incentive to properly maintain and expand the system.

If any price cap is to be set, it should apply only to those areas that were connected at a subsidised rate for community service reasons. For the rest, the initial price should be established as if contracted at present levels, with downward pressure on incumbents' prices provided by rival suppliers. After all, customers have willingly connected at the present price and suffer no disadvantage from the status quo.

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[4] Hilmer, F., M. Rayner & G. Taperell (1993), National Competition Policy: Report by the Independent Committee of Inquiry, AGPS, Canberra.

[5] Baumol, W., J. Panzar and R. Willig (1982), *Contestable Markets and the Theory of Industry Structure*, Harcourt Brace Jovanovich, New York

It is likely that a well-structured competitive regime on wires and pipes would simply ensure that all barriers to entry were removed and that the incumbent businesses were unable to block new rivals. The New Zealand regime operates very successfully in this way without any price regulation (the breakdown of electricity supply into Auckland in 1998 was unrelated to this feature).

No facility–at least no facility unprotected by government franchise–has untempered monopoly powers. Many facilities can be by-passed and almost all others supply products, like gas, that compete with electricity. That facilities have an *element* of natural monopoly is not cause of itself for an expropriation, even in part, of property rights. The alternative to a market based on the assignment of unfettered property rights may be significant under-investment in new pipes, rail or other infrastructure, with a significant loss to suppliers and consumers.

Auctioning the Right to a Monopoly Facility

Should it be determined that only one facility is economic and there are many suitors for it, one option is to auction its approval. The selected supplier is the one offering the lowest charges or other benefits.

This is an option favoured by the gas Code. While more market-oriented than most options, there is seldom a situation where several suitors would be available unless the opportunity to build the pipeline has been previously suppressed by government regulation. And if a proposal is to be opened to tender by those who did not spot the opportunity in the first place, the incentive to search for new ways to profitably meet consumer requirements will be reduced.

Control of Mergers

The Regulatory Framework

The other arm of regulation to promote competition covers takeovers and mergers.

The form of natural monopoly that was the harbinger of contemporary merger laws was monopoly obtained by entrepreneurial excellence. The US Sherman Act 1896 was targeted against the Rockerfeller dominance of kerosene as much as against railroads. In the case of the former, the monopoly lasted for only a few years before new oil finds in Texas and Iran brought a great many new competitors.

The pattern of constant technological change and increasing openness that characterises the world economy calls into question regulations that combat merger activity. Markets are constantly redefining themselves, with market players spilling over into areas that would once have been considered unrelated diversifications.

Draft Merger Guidelines were published by the ACCC's predecessor, the Trade Practices Commission in November 1992[6] following a change in the law that widened the ambit of oversight from one that focused on dominance to one that

[6] Trade Practices Commission (TPC) (1992), *Merger Guidelines: Draft for Comment*, Canberra.

looked more closely at the ability of merged entities to exercise any form of market power. The changed provisions thereby impinged further on the rights of the owners to dispose of their property how they wish.

The Draft Merger Guidelines specify "safe harbours" where mergers can proceed without ACCC scrutiny. They also outline the criteria and procedures necessary to obtain ACCC clearance of mergers and takeovers. The Industry Commission[7] considered these Draft Merger Guidelines to be too onerous, time consuming, excessively focused on consumer price benefits and likely to inhibit efficiency enhancing mergers.

The ACCC and its legislative framework is not fully alive to the twin building blocks of efficiency: competition and property rights. The incentive firms have to seek higher profits–economic "rent" to some–is harmful only where there is a monopoly that cannot be challenged. Monopolies of this nature are very rare indeed. It used to be said IBM was in such a position and the US Justice Department abandoned its decade-long litigation against the firm only when it was clear that its monopoly had disappeared under the avalanche of new rivals. Even firms in a dominant position must behave as though they are subject to competition as long as the market is open to competitors.

Some Issues in Australian Controls of Mergers

Although fewer than 10% of the 150 or so mergers examined by the ACCC each year are opposed in a formal sense, others "voluntarily" change the terms and conditions from those initially preferred. Still other possible acquisitions are not contemplated due to the known hostility of the ACCC. In part these perceptions stem from some high-profile decisions of the ACCC that have indicated a strong ideological position regarding mergers. Some of these are examined below.

Westpac/Bank of Melbourne.

The ACCC received a lengthy submission seeking clearance for a merger between the two banks on 15 April 1997, some twelve days after the merger proposal was announced. It announced its decision on 25 July 1997. During this time the customer uncertainty at the Bank of Melbourne (BML) resulted in a considerable loss of business and the two entities were pressed to agree to the Commission's requirements.

In its examination of the proposed merger, the ACCC addressed six features of the banking market: deposits, home loans, personal loans, small business banking, credit cards, and transaction accounts. Each of these market segments was addressed from the ACCC perspective of whether the segment was a state or national market. The criteria used were the ACCC "safe harbour" rules which allow a merger to proceed if:

- the merged entity comprises less than 40% of the market; and
- the combined market power of the four largest firms is less than 75% of the market or where the four largest firms had more than 75% of the market, the merged firm had less than 15%.

[7] Industry Commission (1996), *Merger Regulation*, Information Paper, Canberra, June.

In terms of overall matters, the existence of four major banks and a great number of smaller entities competing in the various segments should have been assurance enough of continued robust competitive conditions, as the Bank of Melbourne's market share was less than 2%. However in different segments, especially on a State basis, that share would be much more significant.

By considering the market as State based, ACCC managed to define two of the six segments as crossing its threshold. Thus, although the two entities each only had 9% of the Victorian deposit market, this was sufficient to cause "concern". Similarly, although the merged entity had only 20% of the Victorian transaction accounts, "concern" was again triggered.

On the basis of these findings, the ACCC obtained s87 undertakings, which included:

- maintaining significant local decision-making autonomy;
- maintaining BML's extended trading hours;
- preserving the entitlement of existing transaction account customers to fee exemptions (subject to certain qualifications); and
- granting access to their electronic networks by new and small Victorian competitors for their Victorian customers for a reasonable period.

Perhaps the most egregious undertaking is that which requires the payment system to be opened to other competitors on terms that are not considered commercial by the owners. On one plane, payment systems so opened allow more competitors and brings lower costs. But there are considerable investments in devising such systems. If owners of a successful system are forced to make it available to competitors, this reduces the incentives to take the risk of building it in the first place. Firms will await the activities of their competitors and free ride (or cheap ride) on systems that turn out to obtain strong market acceptance. Innovation will be the casualty.

The ACCC makes the mistake of assuming a system is in place and then seeking that its owners allow full use of it by others. The short term gain to competition is a long-term loss to incentive.

<u>Ampol/Caltex merger.</u>
In its consideration of this merger, the ACCC forced the parties to offer undertakings on:

- sale of certain terminals in major cities; this provision was made even though there were already independently owned terminals in Sydney, Melbourne, Brisbane and Perth owned by major businesses and the cost of new terminal construction is only $10-20 million;
- to supply at least a billion litres of petrol per annum on reasonable commercial terms to independents; and
- to sell at least 35 metropolitan and 15 country sites.

There were concerns[8]expressed about:

- the high level of concentration in refining;

[8] See Hearings of the HoR Standing Committee on Financial Institution and Public Administration with Professor Fels Hansard, 21 April 1997; Walker, J. & Woodward L.(1996), 'The Ampol/Caltex Australia Merger: Trade Practices Issues', *Trade Practices Law Journal*, Vol. 4(1), 21- 48. (1996).

- refinery exchange agreements (swaps) and borrow and loan arrangements between the majors that allowed each a presence in States where they have no refinery capacity;
- vertical integration of the majors; and
- the subsidisation by the majors of low retail margins through high refining margins.

High concentration. The ACCC recognised that Australian refineries are old and under-sized. Minimum efficient size is thought to be at least 200,000 barrels per day and may be closer to 300,000. The largest Australian refinery is 120,00 barrels per day and the total demand would accommodate little more than one world-scale refinery. In fact, the concentration in refining is clearly too low for an efficient industry. This is a matter that has recently been highlighted by merger talks between the four majors.

Refinery Exchanges and borrow-and-loan arrangements. The Commission's objection to these seems to be twofold. First, they fuel suspicion of a cartelized industry. Second, they are not normally available to businesses other than those with refining capacity in Australia.

As for the first of these objections, it would seem that if a cartel were operating, it has been highly ineffective. The profits of the oil industry are very low. Moreover, the classic signs of a cartel–stable market shares–are absent. The borrow-and-loan arrangements have been acknowledged by the ACCC's consultant, C. E. Hyde, as contributing to greater competition by allowing a presence in each market[9].

As for the second objection, the rationale behind the co-operative arrangements needs to be understood. If the swaps were to be arranged through the financial system they would attract a taxation penalty. Firms without an ability to offer reciprocal arrangements offer no advantage to those with refining capacity.

Vertical integration. The decisions on whether firms seek to control their production through to retailing is one based on their views of efficiency. Firms that adopt such an approach often see benefits of ensuring a consistent consumer image of the firm, to allow more effective integration of promotional campaigns, and so forth. Commonly, such strategies are combined with franchising to fuse the overall policy with a greater enterprise which is often shown by small business.

The majors' subsidisation of low retail margins through high refining margins and strategies to constrain independent operators. The ACCC has apparently come to a view that the majors act in collusion to pursue particular strategies designed to squeeze out opposition. If this is the case, it has had a spectacularly unsuccessful effect on their profit levels.

Professor Allan Fels, Chairman of the ACCC, stated that the proposed merger would result in a substantial lessening of competition, would bring "unilateral" price increases and facilitate "tacit and possibly explicit collusion", and higher retail prices.

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[9] ACCC, 1996, *Inquiry into the Petroleum Products Declaration*, vol. 2, AGPS, Canberra: Appendix O.

He went on to state that there was little if any prospect of independents supplying petrol,[10] an astonishing statement since it was made at a time when independents (mainly supermarkets) were making massive incursions into many markets across the world. The subsequent entry of Woolworth's into the Australian market was claimed as an outcome of the ACCC's market engineering.

The ACCC in effect tilted the playing field in favour of new competitors, new competitors that did not even have a claim to legitimacy for such treatment that they are small businesses.

Australis/Foxtel

On 14 October 1997, the ACCC announced that it would block the proposed merger between Foxtel and Australis Media. Australis Media had secured access to a key library of Hollywood movies but had done so at a high price. It had been attempting to merge with Foxtel (a joint Testra/Murdoch business) for the previous two years but the ACCC had prevented this.

The ACCC claimed the merger would have given the entity a high market share. The outcome of the decision was to place Australis Media in bankruptcy. The loss of a significant market player occurred in any event. But the shareholders in the company and what the Chairman of the ACCC referred to in a press release as "American junk bond holders" (who had $US375 million at stake) sustained losses.

The ACCC made a determination that the structure of the market required it to take action to ensure that one player, Optus, was not swamped by another. Determining that specific firms should continue in business is a very bold decision for a regulator to make. Sacrificing the interests of one set of shareholders to those of another requires the wisdom of Solomon. Moreover, the market for pay-TV is one with a great deal of fluidity. The content competes with other outlets (free-to-air TV, video stores and the general entertainment industry) and is characterised by very rapid market and technological change (it is likely that means of fast downloading film material through the Internet will provide meaningful competition before any of the present participants are operating profitably).

Different Policy Approaches to Mergers

Competition is not an end in itself: it is valued because economic experience tells us that, as a rule, competition is the best way to maximise the community's welfare through enhanced efficiency. Mergers allow economies to be made. They allow sharing of production and marketing overheads and the rationalisation of facilities. They therefore make possible improved efficiency.

Regulatory measures surounding mergers or merger applications usually seek to forestall price increases. But these may detract from efficiency. Where two firms are engaged in cut-throat competition, the outcome will often be that one is driven out of business or exits the particular market segment. A merger of two such firms can avoid this outcome and restore normal profits in a less socially wasteful manner. Accordingly, it is incorrect to oppose a rationalisation of two business entities on the

[10] Ibid.

grounds that this might bring increased prices. If lower prices are merely the result of a continued existence of surplus labour and capital forcibly retained within a production facility, improved resource allocation can be brought about by their shift to other activities. In this sense, preventing the industry rationalisation is akin to imposing a high tariff to arrest a domestic industry contraction. Although a tariff is designed to bring increased prices, and measures to prevent a rationalisation are designed to bring reduced prices, both can have the effect of establishing a larger industry than economic fundamentals would prescribe.

Hence, in effect actions to prevent rationalisations, especially where there are few entry barriers, are actions to force an enlarged industry and lower prices. With respect to the latter, it is generally recognised that imposing price reductions on competitive businesses (or foreclosing price increases) will detract from efficiency: for example, rent control has been demonstrated to result in a reduction in rentable properties. Similarly, preventing a merger on the grounds that prices would subsequently rise seeks to lock firms into unsustainable positions, forcing them to treat their capital and marketing assets as sunk. It is, in short, a veiled form of price control.

Contestability Theory and Market Concentration

Contestability theory has a particularly important role in areas that are subject to considerable innovation. The ACCC has however taken a static approach to a number of issues that have come before it in areas where technological change is bringing great fluidity in the definition of a particular market. These include the Australis Foxtel proposal. They also include the proposal of Optus to buy AAPT a proposal which the ACCC indicated it is likely to reject because it would remove a vigorous competitor. They also include the proposal of the ASX to buy the Sydney Futures Exchange on the grounds that this would create an undue concentration.

With these moves, the ACCC is discounting the value of contestabilty. It is taking the view that the removal of one competitor will leave the merged entity free to rape and pillage. In point of fact technological change and globalisation make this well nigh impossible. The ASX has almost 100% of stock trades in Australia because it is cheap. If it were not, we would very quickly see a rival foreign exchange offering its services. It was the ASX's ability to exploit economies of scale and scope was stymied by the ACCC reaction to the proposal, not its ability to exploit the consumer!

Intellectual Property Rights

Innovation, Property Rights and Competition

Innovation has been an increasing source of economic growth. Such innovation has been spawned by individual property rights. Lipert[11] traces back the first ever patent to Florence in 1421 to Filippo Brunelleschi. The invention, a loading crane, was granted because Florence wished to attract people of enterprise at a time of considerable commercial growth. Its rival city, Venice, soon followed suit as did the German and Dutch trading cities.

[11] Lipert, O., *Individualism, Intellectual Property and the Future of Capitalism*, Fraser Forum, March 1999, p.8-10

The issue of intellectual property rights is at the centre of the Department of Justice's regulatory intrusion into business with the attack on Microsoft and possibly Intel. Who said attacking "tall poppies" was a peculiarly Australian art form?

With intellectual property rights, the two principles that have driven economic success–vigorous competition for the consumer's dollar and firm property rights–are in collision. Property rights like patents and copyright entail a monopoly. The artist or inventor is given an entitlement to the rewards others obtain from use of the patent or copyright. The owner of the rights will be expected to milk them for all they are worth, the constraint on this being the willingness of consumers to forego purchases and the ability of the producer to exploit the different buyers' strengths of demand (the different parts of the demand curve). The ability to price differentially is restrained by the ability of buyers to arbitrage between different prices, an ability that is massively increased by the internet.

Moreover, the ability to exploit monopoly profits with innovation is limited by the on-going existence of the technology that is being superseded. In the case of computer software, although Microsoft faces considerable *potential* competition from a better system than *Windows*, the immediate constraint is the fact that almost all potential customers for *Windows 2000*, already have a perfectly good substitute in *Windows 97, Windows 95* or even *Windows 3.1*.

The Debate on Parallel Importing of Compact Discs

As intellectual property is assuming increased significance in the goods and services we buy and in promoting economic growth its protection is assuming increased importance. One issue to achieve prominence in this regard is that covering parallel imports of compact discs (CDs).

Although the issue of CD parallel importing[12] is frequently obscured by allegations of multi-nationals ripping off the consumer and artists, it is patently false to see the music industry as an oligopoly, even if that term were to be analytically useful. There are half a dozen major and hundreds of minor suppliers of CDs.

The issue is fundamentally about the conflict between property rights and competition. It is about whether a producer may be allowed to place a caveat on the sale of her material to control its resale–a denial of which forms an important part of the *Trade Practices Act*.

Allowing recorded copyright controlled material to be freely imported into Australia from any other country where it is legally sold, will doubtless place downward pressure on prices. The fact is that in the absence of parallel importing, some material is likely to be priced higher in some markets than in others. Freedom of trade will tend to equalise all prices, normally by bringing them down to those in the lowest priced market. An article in the *Australian Financial Review*[13] estimated the

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[12] This matter is addressed in detail in an article by me in Agenda `volume 6, number 2, May 1999.`

[13] AFR 7, January 1999, *Sanity Records may prevail in slowdown over CD retail prices*, by Kath Cummins, p.6.

wholesale costs of imported CDs to be 50-55 per cent of the cost of Australian-supplied disks.

The lower prices are unlikely to be in the best interests of the copyright owners–if they can charge differential prices, they will obtain higher profits. Although superficially attractive for consumers, low prices are only one component of consumer demand. If they come at the expense of a constrained variety of offerings they may not be the preferred outcome. One single car plant that fully exploited all economies of scale in turning out just one model would not necessarily be beneficial to consumers.

Any firm will seek to segment the market where it can and exploit the demand spectrum by charging a higher price to those with the greatest wish for their product and capability of paying for it.

We see this in a great many markets. There need be no market power, as conventionally understood, to allow the exercise of price discrimination. The "law of one price" normally prevails in open markets but suppliers faced by different demand curves for different market segments will often charge different prices. A long and uncontroversial literature suggests that exploiting different demand profiles through Ramsey pricing promotes efficiency. The difficulty is defining the segments so that the discrimination can take place.

In charging lower prices in some markets, the seller will be keen to prevent higher charged customers migrating to these to take advantage of them. This puts constraints on the ability to structure separate prices. Yet, cinemas and hairdressers charge different prices for pensioners and children, (in the case of hairdressers, children are also more difficult to serve!). By no stretch could the market for these services be said to lack competition.

Implications of removing the ban on Parallel Imports

Almost all products have an element of monopoly which is promoted by branding and differentiation from competitive products. The objective is to earn greater profit. There are practical constraints on the ability to price differentiate across markets as a result of internet ordering. But why should an artist or inventor not try to obtain the best return for his or her product? Although short term price reductions may follow from regulatory action forbidding this, over the longer term it will reduce returns to innovation and the amount of innovatory activity. To put in place restrictions, we must therefore be taking the view that there is too much innovation. This amounts to a new paradigm, which its proponents must justify.

Although the prevention of parallel imports could be seen as an infringement on free trade, it can also be seen as the protection of the property rights of those holding copyright. Broadly speaking, any diminution of the property rights people hold will mean reduced incentives to develop the property rights in the first place. This brings us back to Filippo Brunelleschi and the authorities in mediaeval Florence.

There are three directions for the increased revenues consequent on the ability to differentiate prices:

- to individual record companies if they have some unique skills in pricing by market that are not available to rivals; maintaining such skills to the exclusion of rivals is most unlikely and once rivals have the same skills, the benefits are passed either to:
    - artists with established reputations in greater remuneration or additional promotional expenditures; or
    - artists with no reputation, who will see a greater likelhood of being offered contracts; the potential returns from the cultivation of unknowns is made slightly greater by the abilities of the record companies to earn more revenue by price discrimination and more such risk taking by the CD producers will therefore take place.

No matter in which of these two directions the increased revenues can go in the longer term, they would be efficiency enhancing.

The CD supply market is intensely competitive and any "rents" from price discrimination are likely to fall to the suppliers of the scarce goods: namely the artists. The artist has a unique product and is faced by many possible processors and marketers of that talent. Why should he or she be prevented from seeking the best return for these creative efforts?

In addition to reducing income for successful artists, constraining the conditions of supply to prevent price discrimination reduces opportunities for new artists. A CD producer has a great many options in promoting new acts and would lose money in nineteen out of twenty such innovations. If producers are impeded from seeking to maximise revenue from their products, they must be more cautious in offering opportunities for new performers. Accordingly, price reductions from intervening in market processes may bring a short term gain to consumers but will mean a future loss in diversity of output.

Thus the CD debate cannot be couched simply in terms of requiring freedom of trade. It is also a conflict between the freedom of individuals to pursue their own interests versus one that would constrain that freedom in favour of competition. The issue is, should an artist (through his agent the record producer) be allowed to retain control of his material after its first sale? It is, after all her property and almost anything a regulator does to dictate its use will detract from its value to her.

If it Ain't Broke …?

It might be argued that we, particularly in Australia, are currently experiencing faster growth than at most periods in our history and if there are deficiencies in our approach to property rights and competition policy they are not manifest in any concrete form.

I don't think we can afford such complacency.

Our present growth owes much to the reforms to competition, particularly the disaggregation of electricity, that had their incubus in the Keating Government.

With the reforms to competition policy introduced in 1995, previously sheltered industries in Australia have experienced a massive increase in productivity. Gas and electricity have doubled their labour productivity in Victoria and other States have seen comparable increases. Part of this is due to privatisation, but a major part was due to corporatisation, which placed the businesses themselves on a footing akin to private ownership. These reforms offer a one-time boost, although they still have some juice left in them.

Another aspect of our improved circumstances has been the budgetary responsibility introduced by the Howard Government and in some State Governments. Again, judging from recent Commonwealth and State budgets, the stomach for cutting growth sapping welfare expenditures seems to be abating.

Although we are growing at close to 5 per cent, that sort of growth and more should be easily attainable. We should be doing much better given our expanding labour market and the shortfall of our measured living standards from those of N. America and much of Europe.

Moreover, we should remember that much of our growth has been on the back of capital imports, as indeed was our previous poor performance. The counterpart of these is the current account deficit. The deficit, running at some 5 per cent of GDP is cited by both Moody's (which has Australia on its third highest rating category) and Standard and Poor (which has it on its second highest) as reason for not further improving their rating of Australia.

There is, of course, nothing wrong with capital imports but they must be serviced and paid back. Over recent years, the present level of capital imports has meant the nation's saving effort is reduced but, at some time in the future, that position will have to be reversed.

Concluding Comments

Deregulation has been accompanied by a considerable reregulation of certain aspects of business. This process may be leading us into areas of inefficient resource allocation.

The most significant anti-competitive activity we need to fear in the medium term is that arising from government protected entities. The most important competition policy issue is therefore the elimination of all (unjustified) legal restrictions and interventions in the market which give certain entities (whether wittingly or not) supernormal profits protected from the otherwise inevitable erosion of entry or threat of entry by other firms. At the very least, there needs to be a critical examination of specific cases and an exit from oversight where competition or contestability is possible.

Enforcing open access on transport/transmission facilities and setting a regulated price on that access is likely to curtail the incentive to build new ones and give inadequate incentives for the maintenance of existing ones. Other than where some NIMBY interest prevents any possibility of rival provision–and it is difficult to envisage cases

other than some airports that might fall into this category–the authorities should take the view that the facility is contestable. Regulation should be confined to requiring a price level that has been set in place by the *de facto* contract that prevailed prior to competition being allowed. Competition should then be left to erode those prices that are excessive.

The treatment of mergers and competition policy generally derives from two basic precepts:

- that competition brings dividends in terms of forcing increases in (allocative, productive and dynamic) efficiency; and
- that individual property rights protected by a stable legal system are essential if firms and individuals are to have the incentive to seek out gains from trade and innovation.

Many of those promoting a strong role for competition commissions do so to pursue the chimera of perfect competition.

Yet, there are myriad situations where firms extract higher profits from serving particular groups of customers or where they are able to price-discriminate to squeeze out more profits. In one sense, these activities can be attributed to some degree of market power. But to attempt to dismantle all such hurdles in pursuit of perfect competition would extend the role of the regulatory authorities into requiring one price only to be charged by hairdressers, airlines, and building owners. In doing so and denying sellers the right to exploit different market segments resulting from differing demand profiles, the regulatory authorities would require that some demand that could profitably be met goes unsatisfied.

Workable competition is the best we can ever achieve and, indeed, it is the lure of earning super normal profits that provides the stimulus to innovation and optimum usage of labour and equipment. If mergers result in improved profits, which are their proponents' clear goal, this will often mean higher prices. Attempting to ensure all players remain in an industry means it is ossified, frozen in a time when production and market characteristics allowed more players than can profitably compete at present.

Norman Barry[14] points out that takeovers have helped neutralise the difficulty Adam Smith had with joint stock companies. Smith argued the divorce of management and ownership, so essential for mobilising mass savings in modern business, would lead to managers maximising their own interests and perks. With the development of stock exchanges, the shareholders' remedy of selling underperforming shares prevents this since it leaves the firm vulnerable to a takeover and the replacement of the previous management.

The one unambiguous role for government is to ensure that its laws do not prevent new players from contesting a particular set of demands. Beyond that, the attraction of profitable opportunities and the desire of consumers to obtain good value will conspire to prevent sustained price gouging on the part of suppliers.

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[14] Barry N., *The Ethics of Business*, New Zealand Business Roundtable, Wellington, 1999.