

# Monopoly and competition policy

2nd edition

**W** Duncan **R**eeke

FMF Monograph No. 24

First published in **April 2000** by **The Free Market Foundation**  
PO Box 785121, Sandton 2146, South Africa

Telephone: (011) 884 0270  
Fax: (011) 884 5672  
Email: [fmf@mweb.co.za](mailto:fmf@mweb.co.za)  
Website: [www.freemarketfoundation.com](http://www.freemarketfoundation.com)

© The Free Market Foundation 2000

FMF Monograph No. 24

All rights reserved

ISBN: 1-874930-36-8

# Contents

## Foreword

## The author

### 1 A historical perspective

Introduction

Early history, natural rights and utilitarianism

Revolution in industry – and economics

A century of anti-trust: USA, UK and South Africa

Current issues

References

### 2 Competition policy and its rationale

Efficiency and consumer welfare

Evaluating consumer welfare

*Harberger*

*Williamson*

*Leibenstein*

*Tullock*

*Littlechild*

Who evaluates – consumer or bureaucrat?

References

### 3 South African structure and performance in context

Concentration and ownership

Structure and performance

Implications for monopoly and merger policy

References

### 4 South African Competition Policy

The purpose of the *Competition Act*, 89 of '98

Prohibition of restrictive practices

*Horizontal agreements*

*Restrictive vertical practices*

Dominant firm provisions

*Price discrimination by a dominant firm is prohibited (S9)*

Exemptions from the restrictive practice and dominance prohibitions

*Vertical and horizontal agreements*

*Price discrimination exemptions*

*Merger control*

*The public interest*

References

### 5 *Sub Specie Aeternitatis*

Three approaches and two world views

Conclusions

References

# Foreword

In this *Monograph* Professor Reekie provides an overview of a government policy that has become increasingly controversial. There is accumulating evidence that interference in the voluntary and non-fraudulent arrangements of firms reduces rather than increases competition. Complaints of monopoly are invariably lodged by firms that would benefit from government-induced *reductions* in the efficiency of their competitors or suppliers. Consumers, who are the supposed beneficiaries of competition law, are never the complainants.

As the author points out, the first anti-monopoly laws were aimed at preventing English monarchs from selling monopolies to raise money. No such limitations have been placed on most elected governments and the result has been the granting of monopoly privileges of all kinds to favoured firms as well as the creation of state industries with protected monopolies. Contrary to the fundamental principles of the rule of law, such government-granted monopolies are then exempted from the monopoly laws. Professor Friedrich Hayek maintained that in a free society government can do anything as long as it does not prevent others from doing the same and monopoly protection granted to state industries is inconsistent with this requirement.

The USA's Sherman Act (1890) was the first legislation aimed at interfering in the peaceful and otherwise legal activities of firms. Both the act and the principle on which it was based have been the subject of much debate ever since, and the courts' interpretations of the law have changed considerably over the years as the economic consequences of earlier decisions became apparent. Elsewhere, notably in Britain and South Africa, attempts to regulate so-called private monopolies in the 'public interest' have floundered because of differing interpretations of what constituted the public interest. Demonstrably inconsistent rulings have resulted.

Professor Reekie examines the changes in approach to competition policy adopted in economic analysis, implementation and court rulings in the USA, the UK and South Africa since the introduction of competition law in those countries. Economic analyses that were generally accepted in 1890 were subsequently found to be invalid. Size, structure, conduct and performance of firms have all been examined and no definitive rules have been found to guide the implementers of competition law, or more importantly, to guide entrepreneurs in their efforts to avoid transgressions.

Professor Reekie analyses the stated purposes of the new Competition Act (No.89 of 1998) and questions whether some of the objectives, such as employment promotion, expanding opportunities in world markets, ensuring equitable opportunities for small and medium-sized enterprises, and increasing the ownership stakes of historically disadvantaged persons, should fall within the ambit of competition policy. These objectives, he maintains, should be achieved by other more appropriate means. Competition law aimed at achieving its pure theoretical objectives already fails to provide the certainty required of good law. Including other, sometimes conflicting objectives, ensures that there will be great uncertainty and endless litigation. The economy in general, investors, taxpayers, and the consumer will bear the cost.

The aim of legislation regarding monopoly and competition policy, Professor Reekie concludes, should be solely to protect consumer welfare, and enforcement should be characterised by consistent application of sound economic principles. This would lead to more predictable and appropriate rulings, which in turn would create a more stable business environment. Since unwarranted inhibition of entrepreneurial activity eventually translates into a loss of consumer welfare, this monograph is in the final analysis a voice in defence of the interests of the consumer.

The views expressed in this *Monograph* are those of the author and are not necessarily shared by the members or staff of the FMF.

**Eustace Davie**  
Director, FMF

## The author

Duncan Reekie is E.P. Bradlow Professor of Industrial Economics at the University of the Witwatersrand in Johannesburg, previously Lecturer and subsequently Reader in Business Economics at the University of Edinburgh, 1969-1983. He held the position of Dean of the Faculty of Commerce in his current university from 1989-1994. Educated at the Universities of Edinburgh and Strathclyde he has held Visiting Professorships in the USA, Canada, and the UK. A specialist in industrial organisation he has published in, among others, *The Economic Journal*, *The Journal of Industrial Economics*, *Applied Economics*, *The South African Journal of Economics* and *The Australian Economic Papers*. He founded, and for ten years edited, the journal *Managerial and Decision Economics*. From 1995-1997 he was President of the Economic Society of South Africa. Currently he is Chairman of the Economics Department at the University of the Witwatersrand.

# 1

## Introduction

### Introduction

South African competition law is of relatively recent origin. It is embodied in *The Competition Act* (Act 89 of 1998) which replaced *the Maintenance and Promotion of Competition Act* (Act 96 of 1979) and came into operation in 1999. Prior to the Act of 1979 the 1955 *Regulation of Monopolistic Conditions Act* had been passed but its provisions were both parsimonious and little used.

In contrast to the relatively short life span of competition policy, which is essentially a negative instrument used by the state to tell businessmen what they cannot do, positive industrial policy instructing or encouraging businessmen to choose particular actions has a longer and less ambiguous history. The government owns several nationalised or parastatal corporations (e.g. Eskom, Telkom, the Post Office, Transnet, the Land Bank, Armscor, Denel and the IDC). It also owns significant equity stakes through the Industrial Development Corporation (IDC) and the Small Business Development Corporation (SBDC). The IDC was formed in 1940 to foster the development of allegedly high-risk industries towards which private investment, it was argued, would not be attracted. (This was also the reason given for the establishment of ISCOR in 1927 as a nationalised iron-and-steel firm, although iron and steel production did not begin with ISCOR. Prior to 1939 the United Steel Corporation, among others, was producing significant volumes of steel, while in the post-war period Highveld Steel and Middleburg Steel became major producers of specialised steel products).

The IDC continues to hold 300 million ISCOR shares. It also holds 170 million shares in SASOL (the now partly privately owned oil-from-coal giant) which was originally established for politico-strategic reasons. Another 'strategic' investment of the IDC is the Atlantis Diesel Engine company; other holdings include joint ventures (sometimes to induce investment, sometimes to rescue ailing firms) with foreign or domestic firms. Examples of these include organisations such as Safmarine (shipping), Alusaf (aluminium), Richards Bay Minerals, Siemens and Foskor (fertilisers).

The IDC's rationale, of course, has always been somewhat ambiguous. On its foundation in 1940 there was no evidence that investors were unwilling to expend large sums of capital on projects of high risk with a long payback period. At that stage, however, investors simply believed that the mining sector rather than manufacturing was where the country's comparative advantage lay. The IDC's existence can, nevertheless, be argued for on either 'infant industry' or 'strategic' grounds. It is also seen by some as having the portfolio management experience and expertise to indulge both in nationalisation and in sectoral selection and encouragement, the latter falling under the general rubric of 'industrial policy'.

There is then a dichotomy in actual or intended government policy towards industry. There are agencies such as the IDC and nationalised firms that have substantial administrative discretion. But there are also the Competition authorities, whose objective under either the 1998 Act, or the earlier legislation would be somehow to confine such discretion if exercised by management in private industry. The purpose of this *Monograph* is to examine the latter part of this dichotomy and comment further on its appropriateness, particularly with regard to monopoly, merger and restrictive practice legislation (I have already discussed the former aspect of the policy split in FMF *Monograph* No.10, *On Industrial Policy*).

### Early history, natural rights and utilitarianism

Ambivalence towards monopoly has a long history. In England, Queen Elizabeth I and earlier monarchs could grant exclusive trading rights and privileges relating to specified commodities or new sources of imports. When in need, they sold monopolies to augment revenues (for example for

soap boiling in London). Parliament resented this practice and in 1623 passed the Statute of Monopolies, which made it unlawful.

The case against *government-awarded* monopolies was reinforced by natural-rights philosophers such as John Locke (1623-1704) and Thomas Jefferson (1747-1826), who argued that the individual's inalienable right to life, liberty and property implies the right to enter into any voluntary, mutually acceptable exchange and to retain any property arising from such a trade. Consequently it is wrong to interfere with such transactions, and equally wrong to outlaw or regulate voluntary contracts, such as particular forms of business organisation, since that would impinge upon the natural right of individuals to do with their own property as they saw fit.

Legislation banning the monarch from awarding monopolies (preventing others from trading) is therefore consistent with this natural-rights view of an economy. Anti-monopoly laws as we know them today – discouraging certain types of voluntarily-created business enterprises or agreements – are inconsistent with this concept.

By the eighteenth century government-created monopolies were unusual and generally required special acts (as for land purchase to dig canals and build railways). In ordinary trade and industry, parliament in the UK neither created monopolies nor did anything to prevent private citizens from creating them if they could. The only constraint on private monopolies was the common-law doctrine on “restraint of trade”, which held that it was legal to draw up a contract in restraint of trade, but such a contract was unenforceable in court.

Adam Smith in the *Wealth of Nations* (1776, p.145) agreed with this legal stance and with the natural rights view that contracts voluntarily entered into should not be outlawed. He also hints, however, at why government might move from awarding monopoly privileges to intervening in business activity:

...people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings by any law that either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies, much less to render them necessary.

While Smith's argument coincides with a natural-rights view, the most commonly quoted part of it is the first sentence suggesting that free-market exchanges may not be in the wider public interest. Groups of sellers may collude, prices may be raised, higher profits may be earned, but the hapless consumer must either do without the goods or pay more. In aggregate, producer and consumer are worse off. Thus utilitarians such as Jeremy Bentham (1748-1832), who argued for ‘the greatest happiness of the greatest number’ conclude that government should intervene in the market process.

The utilitarian view that the subjective values and costs of individuals can be added together in some objective way may be disputed. Nevertheless, utilitarianism and the ‘public interest’ are powerful arguments as to why privately-created monopolies (and not only governmentally-granted ones) should be regulated or controlled.

### **Revolution in industry – and economics**

Smith's writings preceded and Bentham's coincided with the Industrial Revolution, when factory production was substituted for cottage industry technology. With what must have seemed bewildering speed for the people of the time, ever-larger organisations emerged in industries such as railroads, iron and steel, and oil, as entrepreneurs took advantage of the cost savings available from managerial, technological and financial economies of scale.

Professor Frankel (1969, pp.36-7) has given a graphic description of financial economies in the South African context. Describing the rationale for the large mining-finance houses – which sponsored individual mines – he claimed that without the group system “it is very unlikely that the industry could have been developed”.

In opening a new gold mine, the magnitude of the economic and engineering problems were such that the venture, in order to insure the distribution of the risks...had to be sponsored by large...companies...The original share capital bearing the maximum risk, came to be entirely subscribed by one or more of these...houses...; it is not until a later stage, when mining operations have produced sufficient information to make a closer valuation of the prospects of the mine possible, that investment buying by the public takes place...

In the USA what became known as ‘trusts’ appeared in a wide spectrum of industries. Sometimes managerial errors occurred and the creation of large corporations proved to be inefficient. Giantism could be a high-cost form of organisation and, when it was, the firms collapsed under their own weight. Who today remembers US Leather, National Wallpaper, Standard Rope and Twine, or National Starch?

Many, however, were successful and therefore highly visible. From the end of the US Civil War consumers began to benefit from the lower costs and lower prices brought about by large enterprises. As goods became more accessible with the spread of the railroads, small localised businesses were suddenly exposed to the competition of impersonal, distant, larger and lower-cost rivals. Farmers, too, saw their incomes fall as their selling prices dropped during the nineteenth century’s last decades. And since most farmers were also locked into fixed debt repayments, this led to falls in their real incomes.

Thus two important lobbies – small businessmen and farmers – who could appeal to the general US philosophy favouring diffusion and decentralisation of powers were opposed to the trusts and to large (and often distant) business in general. This, coupled with one other factor, the concept of “perfect competition”, resulted in a century of anti-trust legislation which has only recently been re-evaluated.

The concept of “perfect competition” first appeared in 1881 in Edgeworth’s book *Mathematical Psychics*. It would form part of the basic toolkit of many economists for the next century, though Edgeworth’s original definition would be refined and honed considerably.

Perfect competition is a state in which an apparent form of socially optimal structure of firms exists. The situation may be undesirable or unattainable, but it has the advantage of providing a yardstick for industrial or competition policy legislation.

From the theory of perfect competition, anti-trust legislators developed the Structure : Conduct : Performance paradigm (SCP).

In essence, this assumes that firms strive to gain large market shares in order to maximise profits. The striving by each holds each in check and encourages the holding down of prices and costs. But if one or a few firms succeed in gaining high shares, they can set prices higher, thus permitting inefficiency and unfairly redistributing income and wealth. These costs, of course, can be offset by economies of scale or increased innovation. This argument is summarised below.

It is only a small step further to argue that monopoly profits increase with concentration (indeed, in the past many empirical data were provided to support this view) and that industrial structure should therefore somehow be controlled.

<b>Structure</b>	<b>→</b>	<b>Conduct → Performance</b>
<b>Perfect Competition</b> and/or low concentration levels	<b>Price : cost ratios</b> close to unity	<b>Allocative efficiency</b> - prices are kept in line with consumer valuations and <b>productive efficiency</b> (costs are held down)
<b>Monopoly</b> and/or high concentration levels	<b>Price : cost ratios</b> departing from unity	<b>Inefficiency</b> and possible monopoly profits



## **A century of anti-trust: USA, UK and South Africa**

Anti-trust law made its first modern appearance in America's 1890 *Sherman Act*.

The first major compulsory divestiture of assets under the Act was in the 1911 Standard Oil case. Size *per se* (not a 100% market share with a single seller) was judged to result in net harm to the general welfare. Little economic analysis was carried out during the case and 'guilt' was determined by corporate structure alone, not by economic performance.

In later cases size *per se* was not the initial criterion for condemnation. The 'rule of reason' was applied. In the 1911 Tobacco case a trade-off was made. The court decided that economic performance had improved (due to corporate size), yet ordered dissolution nonetheless.

The 1920 US Steel case continued the slight swing away from condemnation of size *per se*. The court did not order dissolution. It claimed the firm had not exploited its market power and had therefore committed no offence.

In the 1945 Alcoa case, however, size was again condemned. Judge Learned Hand accused Alcoa of 'doubling and redoubling its capacity' before others entered the field. Alcoa had to agree to compete less aggressively with those government-owned aluminium firms due to be sold off after the war. (In effect, consumers would then have to pay more for what they wanted from the existing large firms while awaiting supply increases from others). Such decisions do not carry the stamp of rigorous economic reasoning. What they *do* reveal is a populist unease with big business irrespective of benefits provided to society.

The negative attitude to existing structure, or size *per se*, was also applied to mergers or potential structure in the *Clayton Act* of 1914. The *Celler-Kefauver Anti-Merger Act* of 1950 was even more restrictive. It initiated the 'incipiency doctrine' whereby a merger which need not itself result in a monopoly would be banned because any succeeding merger would consequentially be closer to producing one. The 1952 proposed merger between Brown Shoe and Kinney Shoe (which would have resulted in a joint market share of only 5%) was prevented for this reason. Again, the lawyer's concept of monopoly was far removed from the economist's strict 'single seller' definition.

The 1982 AT&T case resulted in dissolution by consent. Twenty-two regional telephone and cable companies were sold. This, however, was the last anti-trust divestiture in America. Furthermore, the AT & T case represented less a historical unease over size and more a desire to break up a government-protected, regulated industry. The case was closer to a UK-style, 1980s privatisation than to an end of the 19<sup>th</sup> century corporate break-up.

This change in US thinking was even more dramatically illustrated in the same year – 1982 – when the IBM case was dropped by the authorities after 13 years of litigation. Most of the government's complaints were that IBM had reduced prices and increased output, which McGee (1988, p.476) points out are 'not exactly the stuff of which real monopolising and consumer injury is made'. This decision marked a watershed in American legal attitudes towards big business. Since then, US legislation has been more rigorous in its application of economics.

An understanding of why this change occurred is crucial to a correct appraisal of what effective competition is. Chapters 2 and 3 provide some of the necessary background for this purpose.

It took 60 years for anti-trust policy to cross the Atlantic to the UK (1948). The following reasons have been put forward for the delay include:

- i. there was no overt and dramatic merger movement in the 1880s and 1890s as there was in the USA. "Buccaneering" equivalents of Carnegie (steel), Rockefeller (oil) and Morgan (banking) did not exist;
- ii. British firms had to compete in export markets, and against imports. American business – partly due to tariffs, partly to self-sufficiency – was apparently less exposed to competition, so the need for regulation was apparently greater;
- iii. academics and politicians saw little mileage in anti-trust legislation. One party was interested in reform through socialism, others were concerned with issues such as social

welfare, Imperial trade preference, the 'Irish question', and the South African War and its aftermath;

- iv. later, in the Depression years, economic policy concentrated on mitigating the slump. Remedies included abandonment of free trade and encouragement of industrial rationalisation. The time was not right for policies that discouraged mergers and corporate growth.

The 1944 *White Paper on Employment Policy* took a different view. It argued that competition would hold down post-war inflation, and that exhortation to the monopolists of labour (the trade unions) to restrain wage demands (i.e. the price of labour), was unlikely to be successful if business was not also controlled in some fashion.

This, coupled with disillusionment with nationalisation within the Labour government, resulted in a swing towards anti-monopoly legislation as an alternative. The *Monopolies and Restrictive Practices Act* was passed in 1948.

UK legislation is conduct-oriented rather than structure-oriented. In other words, a firm or groups of firms will be condemned if behaviour is deemed to result in some specific 'abuse' detrimental to the public interest. This need not be associated automatically with market dominance (although a 33% market share, not a single-seller situation, was enough to trigger off an investigation).

Therefore, British policy is often alleged to be more pragmatic in intent than the US equivalent. The British approach emphasised the concept of the 'public interest', while the US stressed the 'market setting'.

But the 'public interest' is difficult to determine. Professor GC Allen (a former member of the Monopolies Commission) argued that the guidance provided by the Act as to the public interest "consisted of a string of platitudes which the Commission found valueless. It was largely left for the members to reach their own conclusions by reference to the assumptions, principles or prejudices which their training and experience caused them to apply to economic affairs" (1968, p.16). Only after the passing of the *Fair Trading Act* 1973 did anti-monopolies policy explicitly specify that 'competition' should be regarded as a goal. Even there, however, the public interest was included and the Commission had to take account of 'all matters which appear...in the particular circumstances to be relevant'. Nevertheless, the goal of competition did make judgements susceptible in principle to the rigours of economic analysis.

The 1973 Act, moreover, revised the definition of 'monopoly' (from the legal viewpoint) from a 33% to a 25% market share – far from the economist's single-seller situation.

Charges of inconsistency in the UK approach have been made as often as has praise been given for its pragmatism. For instance:

- i. British Oxygen's return on capital of 23-25% was deemed 'unjustifiably high', whereas the Molins Machine Company's 36% was deemed acceptable.
- ii. Turner and Newall's drop in profitability from 42% to 13% was condemned as indicating inefficiency, while Kellogg's fall from 70% to 37% was approved of on the assumption that the decline would continue.
- iii. Lucas, with 95% of the car dynamo market, escaped censure, whereas Roche, with 60% of the tranquilliser market, was argued to have abused its position – thus implying structure is unimportant.
- iv. The two main detergent firms were condemned for entry-detering levels of advertising in the powder market, in which they held a 96 percent share. Their (higher) advertising expenditures in the liquid detergents market, in which they held a 66 percent share, escaped censure – thus implying structure *is* important.
- v. Lonrho was permitted to acquire SUITS (a Scottish company owning House of Fraser and so Harrods' shares) despite pleas that the take-over would damage the career prospects of Scots based in Scotland. A year later Hong Kong and Shanghai Bank's bid for the Royal

Bank of Scotland was rejected by the Monopolies and Mergers Commission for just this reason.

The list could be extended, but suffice it to say that economic trade-offs were rare and what was deemed to be 'in the public interest' in the UK was as unpredictable as what was deemed to be 'reasonable' in the USA. Historically at least, rigorous use of economics was as rare in the UK after 1948 as in the USA after 1890.

In South Africa, with its colonial linkages, factors similar to those operative in the UK delayed legislation. While there was antagonism towards 'trusts', it was essentially ethnically based and directed against either English speakers or their sub-groups.

Economists such as Frankel emphasised that the groups (or trusts in American jargon) increased the availability of capital in the economy by facilitating new saving and investment (see p.4). More efficient forms of risk-bearing – such as the mining-finance houses – were like new forms of production. Innovations of any sort not only replace existing goods and services, but increase the total income of the community by opening more productive investment opportunities.

The mining houses, however, have now become conglomerates, and not only is mining controlled (not owned) by a few dominant corporations, but so too are many other industries, often by the mining-finance houses themselves. As a result, large South African firms began to be scrutinised from both ends of the political spectrum. The recently established (in historical terms) Competition Board stated in its *Second Annual Report* (para 9):

Oligopolies...can (cause) prices to congeal at unduly high levels, while conglomerates can distort competition by ensuring market support for their members at the cost of more efficient outside firms...these...should be under constant scrutiny so that possible abuses can be detected and...corrected in the public interest.

The *Fourth (1983) Annual Report* took a similar position. Paragraph 14 explained why:

...conduct is never unrelated to market structure...both are of the utmost importance for...implementation of competition policy.

In typical SCP fashion, these two reports argue that concentration leads to high prices, inefficiency, and income maldistribution from consumers to producers. Moreover, this maldistribution has greater political implications in South Africa than elsewhere, since most consumers are black and most producers are white. That is why ANC member Albie Sachs (1990, p.167) argued that competition policy is of more importance than nationalisation:

Blacks have effectively been excluded as significant actors in the spheres of finance, production and services. Backed directly and indirectly by the law, whites have exercised unconscionable degrees of monopoly control; training has been manifestly unfair, and racially-based restrictive practices have abounded...The application of anti-trust legislation (to the major conglomerates)...could in fact have implications more dramatic than a drive towards nationalisation.

The Competition Board's reports therefore often displayed the strengths – or weaknesses – which characterise the UK and US judgements. The 'public interest' is the 'final criterion' for evaluation. In 1982 the chairman of the Board defined this as 'the interest of consumers, producers and traders as well as the broad national interest'. The national interest in turn was defined as achieving:

...economic growth, the efficient utilisation of resources, an acceptable pattern of income distribution, a desirable general price level and equilibrium in the balance of payments.

This led unsurprisingly to unpredictable verdicts. The definitions embrace groups whose interests do not necessarily coincide, as well as economic targets which may be mutually exclusive.

For example, in the Alcoholic Beverages report the beer industry's structure, dominated by SA Breweries, was condemned. A dissenting member did, however, argue that the appropriate market for examination should include wine since the products are close substitutes, the presence of each product precluding monopolistic exploitation of consumers by the other.

Again, in the Soft Drinks Industry report, Coca-Cola's large market share was applauded as a consequence of 'normal business practices'. Elsewhere in the report the firm was condemned for awarding additional discounts to tied houses in Soweto and Kliptown. Presumably that was abnormal practice.

### **Current issues**

There is, then, despite the lengthy history of monopoly and competition policy, no consensus on the matter. In the USA reinterpretation of the law has resulted in more rigorous judgements, at least since the early 1980s (not least in the well-publicised Microsoft case in 1999). In the UK and South Africa, significant rewriting of legislation has occurred. How should such new rules be evaluated?

This *Monograph* attempts to provide some guidance. In the next section the rationale for competition policy is presented. The public interest is defined from the viewpoint of the consumer. Competition is seen to be a process which should not be inferred simply from structural statistics. And it is argued that markets for goods, while important, should not be analysed in isolation from the markets in international trade, for capital and for votes. Once the market for votes is accounted for we will discover why the seemingly innocuous phrase "public interest" has been so damaging in UK and South African competition policy history. Pressure groups, small parts of the public, can be more effective in lobbying support than consumers, the general public.

Chapter 3 examines specific structural issues such as size, integration and diversification of industry. Three further reasons (to those addressed in Chapters 1 and 2) are provided for exercising caution in assessing the new South African legislation. First, the South African economy cannot and should not be treated by lawmakers in the same way as other, larger economies. Second, economic theory is hard pressed definitively to predict negative behavioural effects from structural conditions. Finally, and not trivially, it is difficult to select measures of either structure or behaviour which unambiguously demonstrate harm to the public interest from either an actual or potential structure.

Chapter 4 examines restrictive trading practices. Issues such as price discrimination, price parallelism, collusion, and other real or apparent anti-competitive behaviour patterns are discussed.

Finally, some concluding thoughts are offered which, it is hoped, will aid both the critic of the new competition legislation and those who apply it. Harvard industrial economist Joe Bain wrote (1969, p.512):

...the application of the law, in the sense of discovery, identification, and treatment of firms or industries that are in violation of its provisions, should be predictable, impartial, and so far as possible relatively automatic – as distinct from being unpredictable, discriminatory, capricious or heavily influenced by administrative discretion.

### **References**

- Allen, GC (1968) *Monopoly and restrictive practice legislation*, George Allen and Unwin, London.  
Armentano, DT (1982) *Anti-trust and monopoly*, Wiley, New York.  
Bain, JS (1968) *Industrial organisation*, Wiley, New York.  
Frankel, SH (1969) *Gold and international equity investment*, Institute of Economic Affairs, London.  
McGee, JS (1988) *Industrial organisation*, Prentice-Hall, Englewood Cliffs.  
Sachs, A (1990) *Protecting rights in a new South Africa*, Oxford University Press, Cape Town.  
Smith, A (1976) *An inquiry into the nature and causes of the wealth of nations*, Skinner, AS (ed) (1978). The Glasgow Edition, Liberty Press, Indiana.

# 2

## Capital and the business cycle

Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self-evident that it would be absurd to attempt to prove it. But in the mercantile system, the interest of the consumer is almost constantly sacrificed to that of the producer; and it seems to consider production, and not consumption, as the ultimate end and object of all industry and commerce.

Adam Smith (*The Wealth of Nations*)

The power of demanding or refraining from demanding is “consumers’ sovereignty”.

WH Hutt (*Economists and the Public*)

### Efficiency and consumer welfare

Consumer welfare is greatest when society’s resources are allocated in the economy so that consumers are able to satisfy their wants as far as technological and physical constraints permit. In this way the wealth of the nation is maximised. Competition policy’s aim should be to help bring about this result.

There may be occasions when government wishes to achieve other objectives (e.g. to redistribute income or wealth, to promote the interests of historically disadvantaged people, or to encourage environmentally friendly production or consumption) but such alternative goals are not the objective of competition policy. Anti-trust authorities may note such goals, but they are in the bailiwick of other legislators.

Society’s total wealth depends, of course, on achieving overall efficiency in the production and distribution of goods and services. This overall efficiency is composed of *allocative efficiency* and *productive efficiency*. Bork (1993, p.91) claims that the “whole task of anti-trust can be summed up as the effort to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or a net loss in consumer welfare”. Allocative efficiency is achieved when resources are used in industries or for tasks where consumers value their output most. Productive efficiency is achieved by most effectively using resources in particular firms.

Economic theory shows us that a multiplicity of small firms in conditions of perfect competition and producing a homogeneous product (a totally unrealistic and undesirable situation) must achieve overall efficiency. That same theory shows what a single seller (a monopoly) must do in order to maximise profits – again the notion is unrealistic in practice. Alternative, real-life forms of industrial structure lie in between, and here conventional theory – even at an advanced level – is ‘little more than a guess’ about how firms will and do behave (Bork, p.92). Nevertheless, the polar theories are uncluttered, powerful and, even if imprecise, sufficiently adequate in their simplest forms to aid in prediction and explanation and so in policy formation.

### Evaluating consumer welfare

It is only when the theories are muscle-bound and policy-makers are unable to adapt them to the realities of how competition works that they become obstacles rather than aids to successful competition policy. To illustrate their value (and their weaknesses), consider the following five models:

#### *i. Harberger*

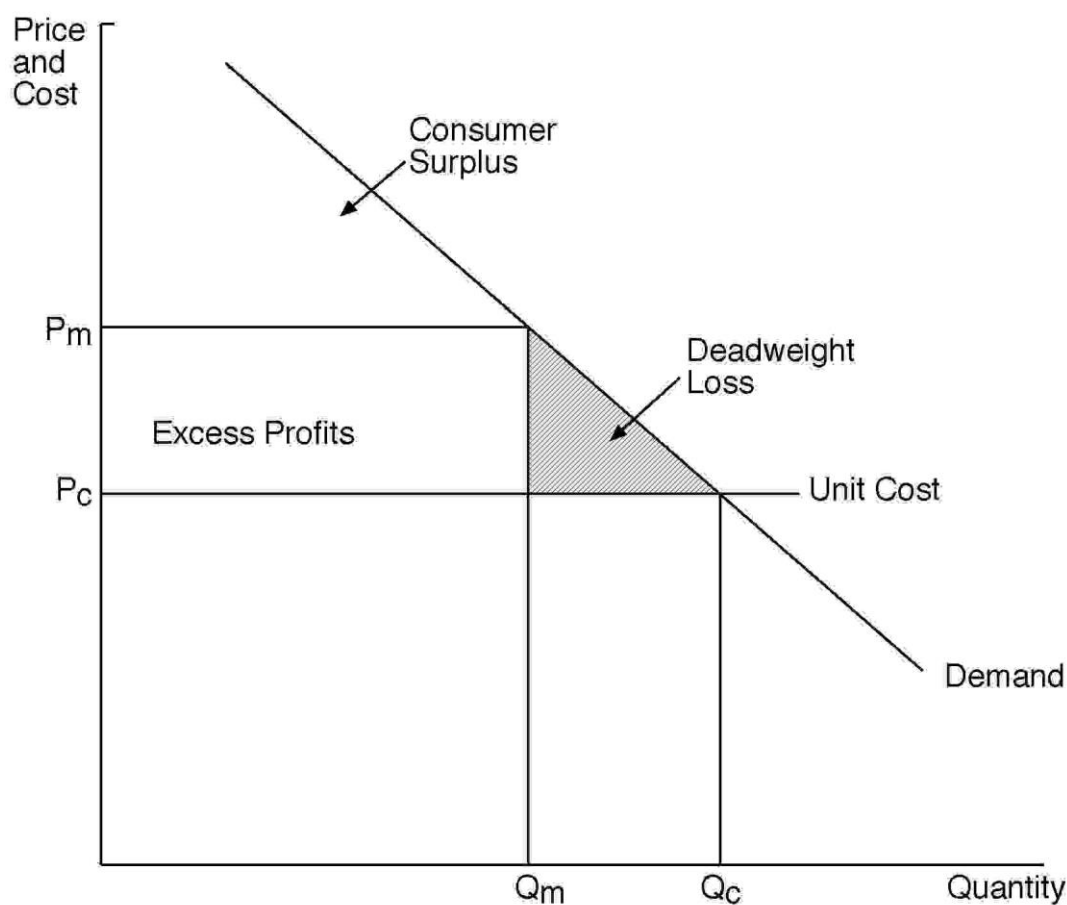
Competition policy aims at achieving overall efficiency. To understand consumer welfare in this context we must understand the concept of consumers’ surplus. Consumers’ surplus is the

value (or utility) consumers gain from buying goods, which is over and above the total price they pay the supplier. It arises because although they pay the same price for each unit, including the last unit bought, all earlier units provided greater satisfaction. (This is explained by the two economic laws, the law of diminishing marginal utility and the marginal equivalency principle of consumer equilibrium which states that the marginal cost – price paid – must equal the marginal benefits obtained.) Geometrically, in Figure 1, buying from a monopolist at price  $P_m$ , consumers will voluntarily buy  $Q_m$ , pay a sum of money in total equal to the rectangle  $P_m \times Q_m$ , and receive also the consumers' surplus shown.

However, if the industry had been perfectly competitive the price would have been lower at  $P_c$  equal to unit costs. The consumer surplus triangle would have been much greater. Monopolisation has resulted in a higher price being paid ( $P_m$  not  $P_c$ ) and the quantity bought ( $Q_m$  not  $Q_c$ ) has been reduced. Part of the consumer surplus triangle has been shifted to producers as excess profits (not a direct concern of monopoly policy since this is a transfer from consumers to producers, who will in turn be consumers in their own right of some other good or service). But part of it is totally lost to society as shown by the dead-weight triangle. This resource misallocation is the concern of competition and monopoly policy.

The first writer to research dead-weight loss was Harberger (1954). Over the period 1924-28 for the USA he estimated it at 0.08 per cent of national income. Nobel Laureate George Stigler (1956) concluded that this, if true, was "so small that economists would be better employed fighting termites than combating monopoly".

**Figure 1**



Harberger's Measure of Monopoly Welfare Loss

## **ii. Williamson**

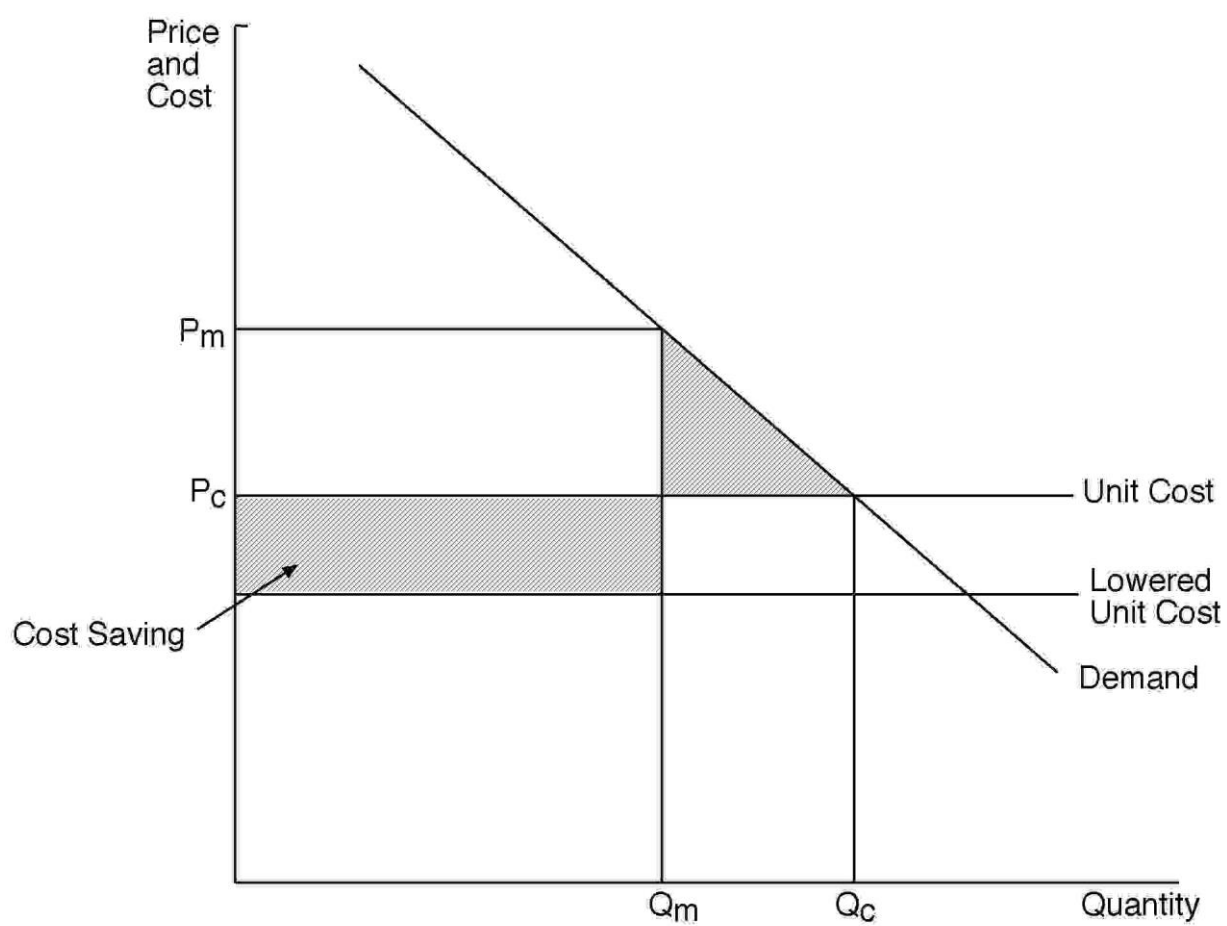
However, the monopolised industry may get the benefits of more efficient production techniques, and so lowered costs (Figure 2). In this case the net welfare gain or loss to the economy is the difference between the two shaded areas. Fewer real resources are used to produce  $Q_m$  than otherwise. The excess resources are released to increase output elsewhere. Oliver Williamson (1968) therefore argued that in judging a merger (or a forced unbundling) policy makers must ask whether the cost savings (or increases in the divestiture case) which will result will be greater than the loss of consumer surplus, and *vice versa*. Bork (1993, p.108) points out that in many cases – in fact in ‘most mergers’ and also in the practice of ‘price discrimination’ – the positions and shapes of the lines on the diagram (i.e. business practice) will be such that only cost savings will arise, price will be unchanged and so no dead-weight loss will occur, only a net gain.

## **iii. Leibenstein**

An alternative argument is that inputs are not used as efficiently in monopoly. Leibenstein (1966) argued that X-inefficiency will exist (this is simply a fancy name for what is called inefficiency in everyday life). As a consequence of increased costs, firms – to maximise profit at new cost levels – may even have to raise price further than  $P_m$  to  $P_m^1$  (see Figure 3). Output will be still further reduced and the dead-weight loss triangle further increased. Excess profits will be less because of the presence of X-inefficiency, and for policy purposes that rectangle must be added to the increased triangle to obtain the welfare loss from monopoly (scale effects have been excluded from the Figure).

Leibenstein’s arguments depend on the notion that in departing from perfect competition there is a loss of competitive discipline and pressure on both managers and workers which results in their indulging in higher-cost, less efficient behaviour. Leibenstein has come under criticism from a variety of writers. Indeed here we have a good example of the confusion of terms. (‘Perfect competition’ from first-year theory is not the same as ‘competitive discipline or pressure’. Perfect competitors in fact are under very little pressure; they simply accept passively a market price. Real-life firms of whatever size have to struggle to raise capital, satisfy shareholders, search for a price at which they can maximise profits without attracting new rivals, and develop new and better products so that they can continue to exist and to attract and pay high-quality managers and workers. A firm, which cannot do these things, cannot maintain its share price on the capital market. Take-over is as sure-fire a way to go out of existence as bankruptcy. Both exert discipline, yet both are assumed away in the simple equilibrium of perfect competition. On grounds such as these, George Stigler queried the ‘Existence of X-Efficiency’. Nevertheless there remains a plausibility in the argument. After all, another Nobel Laureate, John Hicks, argued that monopolists would, if they could, always prefer to live a ‘quiet life’.

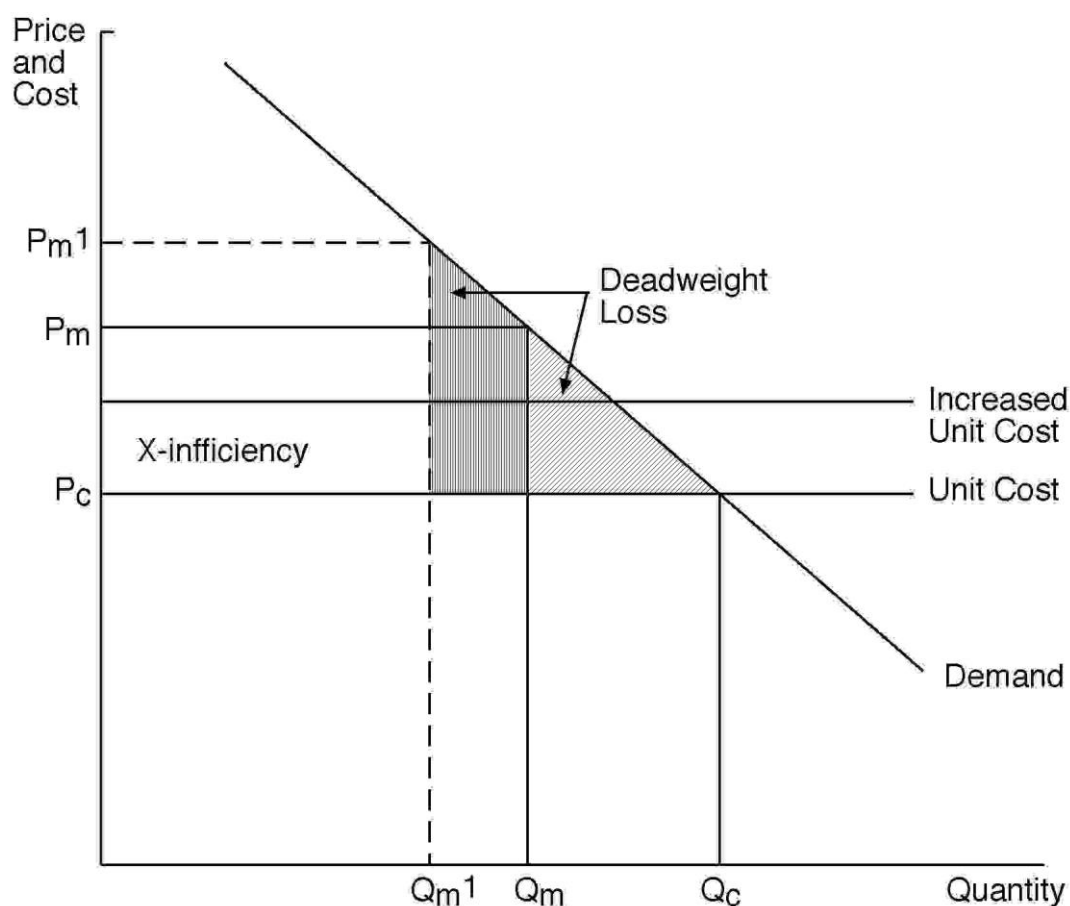
**Figure 2**



Williamson's Scale Economy  
Trade-Off against Harberger's Triangle



**Figure 3**



Leibenstein's X-inefficiency and Increase in Deadweight Loss

#### ***iv. Tullock***

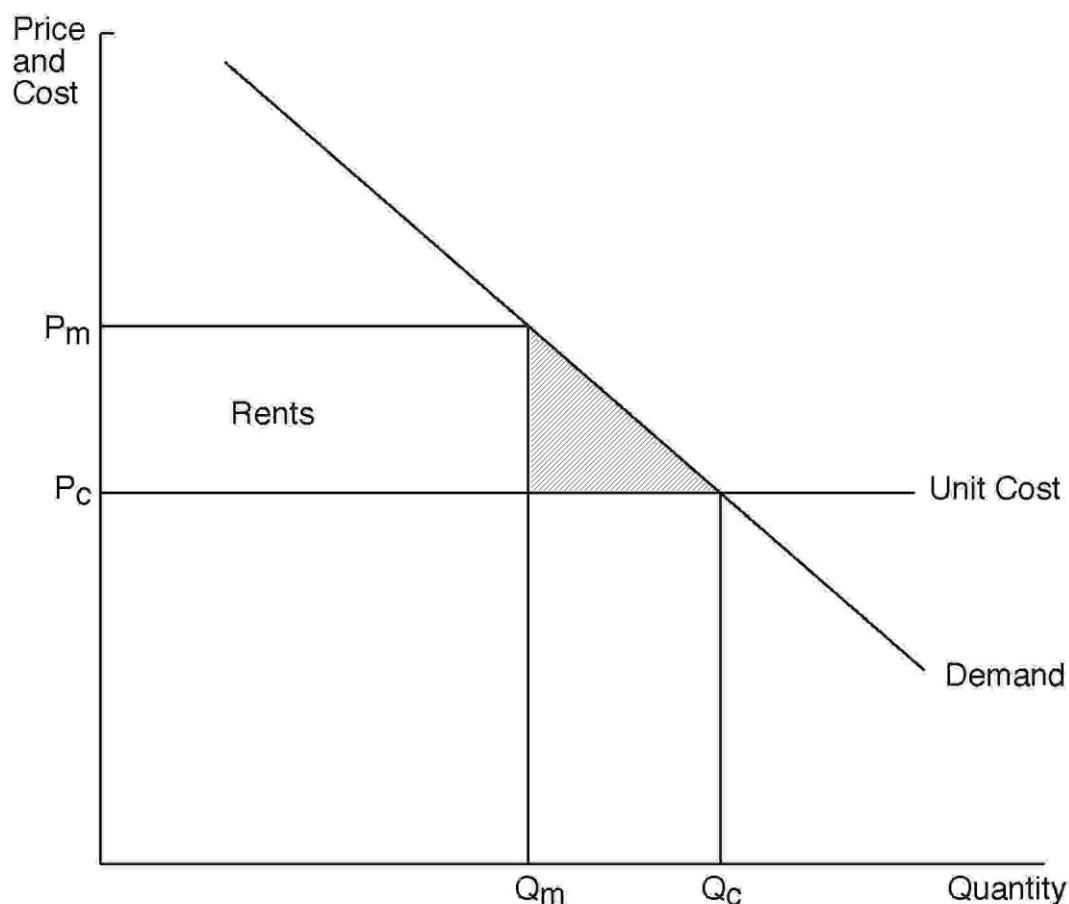
There is, however, a further reason why the dead-weight loss triangle may be too small an estimate of the welfare loss from monopoly. Tullock's (1967) argument (contrast Figures 1 and 4) is that if a successful monopolist can extort the income transfer of excess profits from his customers, then such a large prize is worth the investment of up to an equivalent amount of resources. In Tullock's language, rents (excess profits) justify rent-seeking costs. Indeed, the prize of rents is greater than indicated in either Figure (which is for one period only), and stretches into perpetuity. Customers likewise will be interested in, and willing to make investments in, activities preventing the transfer. Such rent-seeking costs, or counter-costs, are wasteful.

Once established, a monopoly will attract continual efforts to break it down, and further investments will be incurred to protect it. In short, the Tullock rectangle, rents, must be added in whole or in part to the Harberger triangle. The rents (which already exist) will attract 'rent-seeking' costs or investments either to protect their existence in the hands of the producer or to transfer them back to consumers or new entrants. The rent-seeking costs simply result in the transfer of wealth or income; they have nothing to do with its creation. In principle it is worthwhile for firms to incur rent-seeking costs up to a level just short of the value of the rents themselves.

There is worse. Rent-seeking behaviour is most dangerous when firms lay out lobbying expenditures to 'capture' bureaucrats and politicians. In other words, the legal framework

itself and the privileges it can grant to protect excess profits are a prime cause of rent-seeking behaviour. The only sure way to eliminate rent-seeking is to eliminate potential rents, and the only way to eliminate rents (compare Figure 4 and Figure 1) is to eliminate the excess profits – but to do so without the regulatory activity which can lead to rent-seeking – in short, regulation by free competition and market entry, not regulation by law.

**Figure 4**



Tullock's Rectangle as Incentive for Rent Seeking Behaviour

#### **v. Littlechild**

But can free competition and market entry arise without regulation? Littlechild (1981) argued affirmatively. The whole concept of Figure 1, he claims, is often misguided. Competition, in Littlechild's view, should always be regarded as a process, not a state of equilibrium (even economic theorists should discard the static version of perfect competition). Profits, then, are never, as in Figure 1, 'excess', but rather are the outcome resulting from entrepreneurship. Alert entrepreneurs have grasped the opportunity of innovation (technological, organisational, marketing or whatever) and have offered a product to consumers. The demand curve is there only because entrepreneurs have drawn the attention of consumers to the possibility of obtaining  $Q_m$  at  $P_m$ . The relevant alternative, the yardstick for comparison, is not  $Q_c$  at  $P_c$ . Perfect competitors in equilibrium would never have noticed the possibility of change, the opportunity for profit. The relevant alternative is for the good not to have been supplied at all. Thus the very fact of production and sale implies a net social gain equal to the profits plus consumers' surplus to which production and consumption give rise. However it is measured, dead-weight loss is, says Littlechild, an irrelevance.

### **Who evaluates – consumer or bureaucrat?**

Although Littlechild and Tullock come at the issue from different perspectives, together they highlight the problem of outsiders (bureaucrats and politicians) measuring consumer welfare.

Politicians and bureaucrats, no less than anyone else, pursue their own self-interest. Moreover, they do so in an institutional environment which makes it all too likely that their benefit will be at the expense of the public as consumer.

First, there is the role of *information*. The price mechanism provides consumers and businessmen with the information about shortages and surpluses that they need for their decisions. They also have the incentive to gather this information, which government officials do not have. The latter have no property rights in the gains created from exploiting a profitable trade, nor do they suffer directly the costs of error in misdirecting the flows of capital or labour. They will not be alert to the best opportunities and will be less likely to exercise caution in making unpromising decisions. Regulators can therefore be presumed to make damaging and harmful decisions much of the time.

Then, as Tullock showed, there is *rent-seeking*, that is the use of government power by interest groups and individuals to obtain special privileges for themselves. Successful rent-seekers gain above-market returns by successfully lobbying government for favours (and are willing to spend resources either lobbying or on uneconomic behaviour up to the value of these returns in order to attract government approval).

Lobbies representing small particular interest groups such as established firms, fortunate members or sub-groups of specifically-favoured ethnic groups, trade unions or professional groupings are likely to have a disproportionately large influence on government, whereas the interests of large groups, especially consumers, are likely to be under-represented. Competition policy decisions can be lobbied for or against. The ‘losers’ from faulty policy are invariably consumers and taxpayers. The reason for this is that any one policy will appear to them to have a very low cost as the cost is dissipated across consumers at large and is therefore not highly visible. Thus they tend not to organise in opposition since the incentive to individuals to do so is weak. However, to the beneficiaries of the policy (providers of labour and capital in the industry concerned), the benefits are both visible and worth organising for to obtain or retain. Since all (or most) will reason this way, the likelihood that large groups, such as consumers will organise effectively to counter partial and selective so-called competition policies targeted at benefiting specific producers or providers is much less than the likelihood that a small group of producers will organise to obtain the policy outcome favouring them.

Lastly, policy can be shown to have perverse results. The status and success of bureaucrats are often measured by the resources at their disposal. Thus the creation, maintenance and expansion of policy is a ‘good thing’ in its own right for a civil servant. The politician, motivated by power and the desire to stay in office, will readily concur. The ‘benefits’ (e.g. ‘lower prices’, ‘preserved jobs’) from competition policy can easily be pointed to. Political support can be gained. The costs, in terms of alternative job opportunities lost which could otherwise have been created, or goods and services lost which could otherwise have been produced with the resources so used, are invisible and cannot be identified. It is not surprising that activist competition policies have an impressive record of failure and of inconsistency.

The safest conclusion is that there is a role for policy which aims at making markets work. It should do this by deregulating product and labour markets and at removing government-imposed special favours resulting in entry barriers to industries and occupations. Nationalised enterprises should be privatised by restoring the rights of ownership to the citizens of the country. Displaced workers in declining industries can then be given training vouchers to be used for retraining in areas of their choice. And continued and expanded commitment to international free trade would make for a more competitive economic environment at home.

### **References**

- Bork, RH (1993) *The anti-trust paradox: A policy at war with itself*, Free Press.  
Harberger, A (1954) ‘Monopoly and resource allocation’, *American Economic Review*.

Leibenstein, H (1961) 'Allocative efficiency vs X-efficiency', *American Economic Review*.  
Littlechild, SC (1981) 'Misleading calculations of the social costs of monopoly power', *Economic Journal*.  
Stigler, GJ (1956) 'The statistics of monopoly and merger', *Journal of Political Economy*.  
Tullock, G (1967) 'The welfare costs of tariffs, monopolies and theft', *Western Economic Journal*.  
Williamson, OE (1988) 'Economies of scale as an antitrust defence: The welfare tradeoffs', *American Economic Review*.

# 3

## Rival theories and their neglect of capital theory

This chapter examines South African industrial structure. It then looks at the empirical debate that has occurred to ascertain if dead-weight loss exists and consumer harm occurs as a result of South African structure. As in the rest of the industrial world, the evidence here suggests little cause for concern. Indeed, much of the concern is misdirected. Finally, the issue is again raised of how regulators can measure economic harm if they cannot understand either consumer benefit (as non-consumers) or (as non-producers) the meaningful competition required to gain consumer approval.

### **Concentration and ownership**

It is frequently argued that South African industry is highly concentrated. This assertion has two dimensions. First, there is the issue of oligopoly in any given product market. The South African economy from 1950 to 1990 had a small number of large conglomerate companies (by local standards) which resulted in a wide array of otherwise unrelated markets being dominated by subsidiaries of the same six or seven large groups. Secondly, the formal capital market (i.e. the Johannesburg Stock Exchange) was also highly concentrated in that control (not necessarily ownership) of over 80 per cent of the capitalised value of all listed companies was concentrated in the hands of only six groups (two of which were mutual insurers).

Given the apparent concentration of economic control in the hands of a few conglomerates, it is worth recalling a number of points. First, the South African economy is relatively small. Therefore, in industries where large scale is necessary, large companies are unavoidable and the number of firms in such industries will be small. Secondly, politically motivated disinvestment reduced the number of overseas companies willing to be seen operating in South Africa. Disinvestors sold their operations to domestic firms, so increasing concentration both within the market sector concerned and at an aggregate, cross-economy level.

Furthermore, concentration in the past has very often been further politically induced, either indirectly or directly. For example, tax breaks enabled life assurance companies to offer policy-holders after-tax incomes at a more beneficial rate than the saver could obtain by investing directly in corporations or unit trusts. This no doubt is one reason why South African individuals hold more life assurance cover per capita than their European or North American counterparts.

Interest payments are not deductible as expenses against income (as in North America), other than investment income. Thus job-related housing-bond subsidies were encouraged which diverted individual wealth holdings from corporate investment towards the financing of domestic residences. Also, until the 1990 Budget, dividends were effectively taxed twice, albeit partially: company tax was levied on profits, and personal income tax at the recipient's marginal rate was then payable on two-thirds of the dividend. This encouraged profit plough back. Existing firms then grew even larger because their growth was subject only to a diluted capital market test.

Furthermore, since the early 1960s (with only a brief interlude in the early 1980s) exchange controls have made overseas expansion by domestic firms relatively difficult. Indigenous expansion, often by diversification, further increased aggregate concentration.

Thus government's use of economic policy indirectly encouraged large firm size and small numbers of rivals.

Concentration is therefore, a matter for concern for both political and economic reasons. There is a strong case for asking the competition authorities to examine the degree and cost of unnecessary state intervention and to discover the extent to which, over the years, these have caused high levels of concentration in certain areas of the economy.

But the concentration of control may also be efficiency-induced. In a recent paper Professor Brian Kantor of the University of Cape Town (FMF *Briefing Paper* No.16, *Corporate*

*Restructuring and Competition Policy*) pointed out that the evolution of the pyramidal structure of the South African economy can partly be explained on the one level by the allocation of economic control (not ownership) to those groups of managers judged by shareholders to be the most competent; and on the other by the wish of owners to retain control by the pyramidal mechanism (disallowed by law in the USA and the UK). This results in a high concentration of control in South Africa and in other countries with similar legal frameworks such as Switzerland and Sweden. In Scandinavia and Switzerland a similar small number of efficient management teams have emerged which, as in South Africa, dominate the relevant national stock exchanges. The added dimension in South Africa is that the control concentration is racially biased (whites as opposed to blacks) just as historically, but no longer, it was linguistically biased (English-speakers as opposed to Afrikaans-speakers).

This racial bias prompted several black spokesmen to argue that 'white' businesses (for example the large retailers) should not be allowed to operate in the traditional black townships, and that purchasing policies of large procurers such as government and the conglomerates should be legally compelled to favour black entrepreneurs, notwithstanding any disadvantageous price differentials. These types of policy proposals are now becoming ever more overt, albeit, as is so often the case, they appear to favour producer interests (i.e. emergent black businessmen) rather than the interests of consumers (black or white) and providers of finance (black or white) – since, after all, most black consumers would choose to buy from the cheapest sources irrespective of ownership, and most black savers (contractual or otherwise) would choose to invest in media offering the highest returns (usually companies or financial institutions loosely, but incorrectly defined as 'white business').

Indeed, as Frankel pointed out, the mining finance houses were a financial market place innovation in their day and they were the first to evolve into complex pyramid structures. The exploration company was effectively controlled by the operating company, which in turn was linked to a holding company ultimately controlled by the finance house. All four tiers were usually quoted on the JSE so that investors could choose to own shares in whichever level best suited the degree of risk they were prepared to bear. As time passed, and especially as the regulatory and political constraints of the 1960s to 1980s came into play, the pyramids themselves tended to become interested in a wide range of other industries.

Tight control of some of the companies within the groups can be achieved with an ownership stake in the parent company of less than 5%. This controlling share usually represents a large proportion of the wealth of the controlling families. The former mutual life insurers Sanlam and the Old Mutual typically own a much larger stake, about 30% or more of their group companies. The pyramids began as owner-managed firms. Successful ventures expanded by reinvesting profits and by attracting outside capital from banks and more rarely from minority partners. Since the controlling founders have the power *inter alia* to determine the salaries they pay to managers and to themselves, outsiders have little protection and trusting partners are hard to find. Outside shareholders have to rely on the desire of the controlling shareholders to maintain their reputations as custodians of other people's wealth. However, their investments are usually safe as a reputation for fair play and good management by the proprietors on behalf of minority partners is essential if capital for further expansion is to be raised by them on favourable terms.

There are few limits to the expansion of successful firms other than their ability to raise capital. For the few firms with controlling shareholders of great achievement, prospects and good reputations, raising additional share capital need not prejudice their control. Though control becomes less secure as outsiders come to own 50% of the shares, this barrier may be easily circumvented by the issue of low-voting or no-voting shares where regulations permit. Where regulation inhibits this, a holding company could be formed to hold a 51% controlling stake in the operating company. The original controllers would keep 51% of the holding company and sell 49% to outsiders. Outsiders would then own 49% of the operating company directly and half of the remaining 49% or 25% indirectly. They would therefore own and receive 74% of the dividends from the operating company without being in any way able to control its management.

In the US, UK and South Africa, unlike for example continental Europe, the issue of non-voting or low-voting shares was made difficult by laws and stock-exchange regulation. But South African entrepreneurs were able to achieve exactly the same results with the consent of majority partners by forming holding companies, cross-holdings and voting trusts. They did this to maintain control while raising extra capital for expansion. At times the aim of the expansion was to diversify the holdings of the key operating company, whose wealth had become too dependent on the original single line of business activity. The controllers thus became the controllers of a conglomerate, without giving up control.

Nobody is forced to invest in tightly controlled companies. Any purchase or sale is at a market-determined price. As with all share investments, such transactions come without guarantee. Only time can tell whether the trust placed in the controlling shareholders and in their abilities as controllers of managers and as managers of assets is justified. Though a few South African family-controlled groups have been trusted in this way and have been able to expand without giving up control, they represent exceptions, not the rule. (A fuller discussion of this thesis is presented in Barr, Gerson and Kantor (1995.))

Clearly care must be exercised. To the extent that regulations have resulted in concentration of control (in the private and state sectors), deregulation and privatisation will deconcentrate. Indeed in the 1990s as exchange controls were relaxed (but still not removed) voluntary “unbundling” became commonplace. But to the extent that pyramid structures are efficiency-induced (as Frankel and Kantor argue), then divestiture policies could have heavy costs for consumers.

### Structure and performance

South African political attitudes to big business reflect the ambivalence of history, as did ‘trust-busting’ US President Theodore Roosevelt:

‘Th’ trusts’ says (Roosevelt) ‘are haejous monsther built up be th’ enlightened intherprise iv Th’ men that have done so much to advance progress in our beloved country’, he says. ‘On wan hand I wad stamp them under fut; on Th’ other hand not so fast’.

Source: Finley Peter Dunne’s fictional Irish immigrant – philosopher Mr Dooley summarising President Roosevelt’s views. (Cited in Scherer, 1980)

America’s ambivalence continues today. As was seen, statute law is tough, yet its implementation and interpretation is either inconsistent or has lapsed. European ambivalence is built into the legislation where case-by-case investigations or ‘abuse’ are more common than simply attacks on structures *per se*. Flexibility to interpret alleged ‘abuse’ unfortunately lends itself to inconsistency.

This ambivalence has its roots in common sense, as Mr Dooley emphasised. It also has roots in the problem of how, if at all, dead-weight loss should be measured. And, very importantly, the structure : conduct : performance model (SCP) which underpinned much antitrust activity in the US and Europe from the 1940s through to the 1960s has been found to be inadequate.

WG Shepherd (1985, p.2) summarised the SCP paradigm (compare p.6) as follows:

- i. in every market firms try to attain and exploit large market shares as they attempt to maximise their profits;
- ii. when these firms’ strivings hold each other in check, no firm is able to capture a large market share. The result is a healthy process of competition, which holds down prices, forces firms to be efficient and stimulates innovation;
- iii. but if one or several firms do attain high market shares, they can usually get extra profits by setting prices above costs and restricting output. Their *monopoly* power can impose social losses by causing inefficiency, a retarding of innovation and unfair shifts in income and wealth;

- iv. these costs of monopoly may possibly be offset, in part or in whole, by benefits from scale economies or an *increase* in innovation. (Emphases in original.)

It is but a small step from a model of this kind simply to argue that monopoly profits will increase with the concentration of the market. Joe S Bain (1951) was among the first to spell out this relationship explicitly. He argued that successful *collusion* between firms would approach or result in joint monopoly profit maximisation. The ability to collude would increase with concentration and so, other things being equal, monopoly profit rates could be expected to increase with concentration as collusion became progressively more successful. This statement, of course, rests on the implicit and unproven assumption that it is cheaper to police collusive agreements when firms are fewer in number. If they are few, then such small numbers, accompanied by high profits, are viewed, possibly incorrectly, as proxies for the degree of collusion and monopoly profit.

What *empirical* evidence is there to support the view that price : cost ratios are greater in more concentrated industries? (Chapter 4 examines the *theory* of collusion in greater detail.) Is there any evidence to suggest that if such higher margins exist they are due to the desire of firms in concentrated industries to maximise joint profits? The premise that there is a link between concentration and monopoly profit rests largely on quantitative studies published during the 1950s and early 1960s, primarily using US data (and in the 1970s using UK and European data). Nearly all the US investigations used data from the 1950s excluding Bain's pioneering work, which was based on statistics drawn from the latter part of the 1930s. Bain divided his sample into two halves, most and least concentrated. He found a statistically significant difference between rates of return. This conclusion stimulated further research which at first tended to confirm that there is a link between concentration and successful collusion.

The American economist L Weiss (1971) cited a further 23 similar studies which had been published by 1969. Most of these seemed to reveal a weak but nonetheless positive relationship between the two variables. Weiss concluded that 'practically all observers are now convinced that there is something to the traditional hypothesis...I doubt that we need many more general concentration-profit studies'.

Two later papers by Yale Brozen (Chicago) and one by Harold Demsetz (UCLA) did, however, cast doubt on the empirical relationship between concentration and profit rates. These papers have often been cited as the starting point of 'the new learning' on concentration. In fact no one explicitly asked why high profit rates persisted over time until Brozen did in 1970. He argued that *if there is successful collusion* in concentrated industries, then the above-average *profits should persist over time*. The above-average profits would represent a non-competitive equilibrium; that is, no forces would operate to disturb that situation. On the other hand, if Bain's findings represented disequilibrium, they simply reflected states of transition. Brozen suggested that *profit rates in industries with above-average returns would decline* and those in industries with below-average returns would rise. For one, there would be new entrants in the industries with above-average returns, obviously attracted by higher profits. Capacity growth and supply increases would result in price falls, and rates of return would converge on the average. Conversely, capacity would contract and rates of return rise in industries with below-average returns as some firms would be driven to the wall and others would leave. Brozen found that most of the industries in Bain's sample did indeed perform in the manner he suggested (i.e. industries with high profits at a given point did experience declines in profits over time, and *vice versa*).

Brozen's findings proved unexpected and puzzling to many. In particular, he faced the challenge that he had examined industries which were concentrated during the period of the original studies, but which had ceased to be concentrated during the period of his replications. To the extent that this was true, Brozen argued, there is little cause for concern since, if the SCP model does hold true at any point in time, then market forces will themselves deconcentrate the industries and reduce the monopoly profits flowing from collusive behaviour.

The initial problem remains. Why should all concentrated industries tend simultaneously to have higher profitability as the evidence suggests? Is it because of collusion by a few large firms?



Demsetz (1973) approached the problem from another angle. The earlier studies linked monopoly power and concentration by suggesting that fewness in the number of firms in the industry facilitates collusion to restrict output and raise price. Demsetz argues that *there are reasons other than collusion for expecting a positive correlation between concentration and profitability*. An association between market concentration and rates of return should be expected from any workable incentive system that rewards superior performance.

Superior ability in lowering cost or in improving products, be it the consequence of luck, entrepreneurial or managerial foresight or the presence of scale economies, may well increase profits and draw sales from the unsuccessful towards the successful and efficient firms. Thus, concentration and profitability could be associated for reasons totally unconnected with collusion and contrived scarcity. In a word, they arise from efficiency reasons. Such situations may (and Brozen's work suggests do) erode with the passage of time as new entrants or existing competitors emulate or improve upon the activities of the successful firm. But unless the short-term monopoly rewards (price : cost ratios above unity) are significant in both amount and duration, there will be no incentive for firms to be efficient, to conduct themselves in ways which would gain those rewards.

Higher profits and increased market share are specific to the firms that perform well in terms of productive efficiency or innovation. Other firms in the same industry which do not satisfy customers by producing appropriate products of the appropriate quality at low costs of production do not share in such higher profits. Demsetz argued, however, that if the only source of higher profits is in fact collusion, then all firms in a particular market should share in these profits. The issue then becomes one of discovering the sources of profitability in concentrated industries.

We can do so by examining the association between concentration and rates of return for those firms that are relatively small in their respective industries.

If there is collusion, it will benefit all firms in the industry. Superior efficiency, however, will benefit only those firms that can more readily attract customers. Demsetz's results (relating to the United States) failed to reveal the predicted benefits that small firms would derive from collusion in concentrated markets. Smaller firms in concentrated industries were actually no more profitable than smaller firms in other industries.

The SCP paradigm is no longer undisputed. This is a remarkable change from just 25 years ago. When Weiss argued that further testing was no longer required. Indeed in sharp contrast, Weiss now doubts that any more concentration-profits studies could even be published, but for a much different reason as shown by the following exchange from a special Department of Justice (US) seminar (cited in Hazlett, 1986):

*Leonard Weiss.* I used to believe that the concentration-profits data provided a meaningful statement, and so I didn't go a lot further in my search for data. I no longer do. I think Demsetz and Peltzman have won that battle

*William Shepherd.* I don't agree with Leonard that Harold Demsetz and his Chicago colleagues have won this battle. The tide of debate is mainly in the other direction; Chicagoans have just raised interesting, but by no means conclusive, questions about concentration. And they haven't given any significant evidence against the positive relationship between profits and market share.

*Leonard Weiss.* Oh, it's conclusive. A large proportion of our colleagues won't believe the concentration-profits relationship. They look at them as very equivocal results at this stage.

*Voice from the Audience.* The relationship may reflect scale economy as well as monopoly power.

*Leonard Weiss. Well, scale economy, superior management, or superior product or all kinds of things. As a result, I don't think you can publish a concentration profits article any more (my emphasis).*

South African data provide (on a static basis) results similar to those of Bain. But when the figures are neutralised for scale, efficiency and innovation, the Demsetz revisionist view also holds here. Small firms in concentrated industries do not appear to derive monopoly benefits from sheltering under a monopoly-contrived price (Leach 1992 and 1997).

This is a particularly interesting point. Concentration of ownership and control in South Africa is far higher than in the United States. It seems, however, to have merely been an alternative route towards efficiency. The performance of senior managers has been doubly monitored by the concentrated shareholders, who have had a clear interest in doing so. In the United States more diffuse ownership has tended to promote monitoring by take-over, which has resulted in considerable increases in share value, a clear indication of previous managerial incompetence. What are the implications for the SCP (Structure : Conduct : Performance) paradigm? One is that it is redundant. A second less extreme view would suggest that the relationship runs in the reverse direction not  $S \rightarrow C \rightarrow P$  but rather from  $P \rightarrow C \rightarrow S$ .

Superior efficiency or innovative behaviour, superior management, and/or successful exploitation of scale economies draw sales from the less successful to the more successful firm. Concentration of industry (large market share) is a direct result of this effective competition.

Such positions can and will erode with the passage of time as new entrants or existing competitors emulate or improve upon the activities of the successful. On the other hand, if the successful continue to satisfy consumers they will maintain their dominance.

The whole SCP model on which anti-trust policy has been based for most of the century is in question. Good-performance (efficiency) leads to consumer-attracting conduct (prices and products) which leads to concentrated markets. Provided there are no governmental barriers to new competition such as tariffs, parastatal monopolies, professional cartels or other statutory protection devices, market forces will reward successful firms and will by themselves deconcentrate any industries where inequitable monopoly profits exist.

This 'new learning' is not really novel. It is simply a resurrection of the natural-rights approach to trade and exchange. This assumes that private property is respected, owners are motivated to use their property more productively than would any third party, and the monarch or state is denied the authority to infringe such rights by granting monopoly power or sole-seller authority. A sole seller should exist only if he is selected voluntarily by consumers because he meets consumer wants better than any alternatives. Immediately someone else can better satisfy such wants, a monopoly vanishes. To exploit such a position by monopoly pricing – without government restraints such as tariffs, professional codes of conduct or nationalised firms – simply attracts imitators who would undercut the monopolist. The combination of monopoly profits and absent government is as attractive to entrepreneurs as honey to bees.

To recap, successful firms acquire increasingly large market share. Markets therefore become concentrated because of *conduct* (pricing, innovation, successful satisfying of consumer wants) which reflects efficient *performance* (in terms of productive efficiency and the holding down of costs relative to what is produced).

However, even this is not enough. Profits, the reward for efficiency, would then attract *entrants*. This would in turn deconcentrate the industries (as successful entrants would result in a larger number of firms). At the same time actual entry, or even the threat of entry would exert pressure on price : cost ratios, so reducing profits. This is likely to happen even if attempts at entry do not succeed. The motor industry is an example of successful entry. (In South Africa Toyota and Nissan entered in the 1970s at the expense of Leyland and Chrysler who eventually withdrew altogether in the early 1980s.) The beer industry is an example of the second point. The following quote from the Scottish economist Tom Wilson should not be forgotten:

Perfect Competition” is not a norm and the fact that it has been taken for one is a remarkable example of the way in which we can mislead ourselves with our own emotive terminology. Indeed the expression “perfect competition” has probably done more to darken counsel than any other in modern economic literature...(Wilson, 1962)

Few industries are ‘competitive’ in the professionally precise jargon of the economist. Static market analysis frequently reveals the presence of monopoly or oligopoly. A more dynamic approach, however, may well show fierce rivalry between market members, a rivalry and degree of competition which enhances the consumer’s power of choice. If consumers use this power by revealing their preferences in the market-place, then those firms which fail to respond may well find their commercial health jeopardised or their market share adversely affected.

Economists often seem loath to accept their own acknowledged advances. It is over forty years since Schumpeter (1950) emphasised that the competition ‘which counts’ is not traditional price competition but rather the continuous and universal search for substitutes, for replacing the less desirable by the more. The substitution begins with consumers seeking to distribute their incomes to their optimal benefit, and proceeds through to producers striving to replace less sought-after products by more sought-after ones and by substituting better ways of producing for less effective ways. The essence of this competition is consumer choice and the response to changing consumer preferences by competing firms:

...the competition from the new commodity, the new technology, the new source of supply, the new type of organisation... competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the output of existing firms but at their foundations and their very lives...(Schumpeter, 1950)

But, and it is a big ‘but’, barriers to competition erected by regulators and lobbied for by vested interests can thwart this process. And the barriers to and distortions of competition in South Africa are legion. Efficient competition policy should direct its attention to these, not to structural variables unconnected with performance.

### **Implications for monopoly and merger policy**

The tough *per se* approach of US legislation is in limbo for good reasons. Article 86 of the Treaty of Rome deals with ‘abuse of dominant position’. The very wording allows for greater flexibility than a *per se* approach. What is dominance? What is abuse? It is difficult to establish a boundary between acceptable behaviour and abusive behaviour.

Indeed the scope for error in both European and American approaches is great. Empirical and theoretical evidence suggests the *per se* approach is simply wrong. Yet detailed regulation (or flexible interpretation of law) depends for its success on the ability of a few people (who may be captured) to judge what is best for consumers. Promoting competition by removing regulatory barriers is probably the better approach. Market competition will then generally outperform the boldest regulator – not least because of its ability to surprise.

Governments can prevent mergers, encourage them, or insist on divestiture. There are strong economic arguments which suggest that when the government does engage in such activity it will often do the wrong thing.

Consider first merger prevention. The ‘failing company’ defence (as in the take-over) is often difficult to employ if the failing company has not, at the time of the proposed merger, failed enough. Mergers can be regarded as a civilised and efficient alternative to bankruptcy and voluntary liquidation. But, especially if a large firm is doing the acquiring, the *prima facie* reason will often appear to regulators to be one of merely increasing market power. Perhaps if mergers were not so actively discouraged there would be fewer bankruptcies. (In South Africa the ‘failing company’ defence has been successfully and correctly employed before the Competition Board, for example by Rainbow in its take-over of Bonny Bird in the broiler chicken market, and by Nedbank in its

acquisition of Finansbank.) To assess the true situation, the market that should be examined is not only the market for the goods in which the merging companies trade but also the market in 'corporate control' (whether this be the JSE or pyramidal holding companies). If this market is imperfect, then managers can deprive owners of higher income from their shares for substantial periods, either through inefficiency or by pursuing non-profit maximising objectives. If it is working well this cannot happen, otherwise the share price of the firm will decline relative to other firms in the same industry. In so far as low share price reflects poor management, it also indicates what the share price could be if efficient management was installed. As a consequence, a merger or take-over attempt will occur in order to transfer the inefficiently utilised assets into the hands of those who can manage them more effectively. The potential capital gain in the share price will be the attraction that initiates this event.

Now consider merger encouragement. If the market in corporate control is working smoothly, then mergers to gain scale economies, and the extra profits which go with them, will take place without government encouragement. If such mergers do not occur, then imperfections in the market for corporate control are enabling inefficient managers to pursue courses of action that are not in the best interests of their shareholders or of the nation as a whole.

In the case of forced divestitures or unbundling these arguments are merely inverted. If the market in corporate control (the stock exchange or a pyramid) is working smoothly, then unbundling to gain the lower costs of reduced administration or X-efficiency, or to gain the additional benefits of managerial nimbleness, will automatically and smoothly take place as owners seek to increase their wealth without government encouragement. If such divestitures do not take place the cause is probably to be sought elsewhere (as, for example, in exchange controls inhibiting the overseas use of moneys received from asset sale at home).

This raises two questions. Is the market in corporate control working well? If not, should not the attention of government agencies be devoted to that market rather than the markets in products? Certainly, if it is working smoothly then there is much less need for government interference, and there are reasons why such interference may be more harmful than helpful.

This argument can be clarified by asking two further questions. First, who loses most from poor decisions? If two firms refuse to merge or demerge in order to gain lower costs, then their joint output is produced at a higher cost in resources than it need have been. This is a social loss, but it is borne *entirely* by the owners of the firms in their lower incomes (we ignore tax losses to government from higher profits, and social losses due to output reduction and higher prices). Alternatively if, say, a conglomerate merger takes place in order to save costs but, in the event, managerial judgement is proved faulty and costs rise, then again the loss is borne solely by the owners of the firms who made the mistake in the first instance.

Secondly, who has the information to make pro- or anti-merger decisions which will be closest to optimal? The answer is and must be those most intimately involved with the situation, namely the members of the industry itself. They have considerably more knowledge of a firm's and industry's cost and demand conditions and prospects than any outsider. This holds for both horizontal *and* vertical merger situations, since knowledge of customers and/or suppliers is part of a manager's stock-in-trade. (Highly specific and publicly unavailable information may be open to official government eyes, but this will be exceptional.)

In other words, it is the members of the industry who have the most to lose from poor merger or demerger decisions and therefore who have the greatest incentive to take correct ones. Outside legislators, however benevolent, have neither the incentive nor the ability to take the optimal decision. And rent-seeking and capture theory shows that the assumption of benevolence must also not be made lightly.

This discussion depends on the smooth operation of the market in corporate control. What actions need to be taken to improve the workings of this market should it prove to be imperfect? The answer lies with information. Information on a company's current and prospective performance should be easily accessible. If the market in corporate control is working well there is little need for either merger encouragement or discouragement by government. Merger prevention is required only

for mergers motivated by a desire for market power outweighing scale economies or benefits from removing inefficient management. Competition policy cannot be based on knee jerk reactions to structures of markets (concentration) or structures of firms (pyramids and conglomerates): it needs to be rigorous. Only through rigorous analysis can we begin to understand the complexities of industrial rivalry and the market process – how in the market-place for goods and services, or in the market for ownership and control, the consumer is being served. In Chapter 4 we examine other reasons why populist reactions to business behaviour (in particular, allegedly collusive behaviour and what are sometimes called restrictive practices) can be based on false inferences.

## References

- Bain, JS (1951) 'Relation of profit rate to industry concentration: American manufacturing, 1936-40, *Quarterly Journal of Economics*.
- Barr, G, Gerson, J and Kantor, B (1995) 'Shareholders as agents and principals: The case for South Africa's corporate governance system', *Journal of Applied Corporate Finance*, Spring 1995, Vol.8, No.1, p.18)
- Brozen, Y (1971) 'The persistence of high rates of return in high stable concentration industries', *Journal of Law and Economics*.
- Demsetz, H (1973) 'Industrial Structure, Market Rivalry and Public Policy', *Journal of Law and Economics*.
- Leach, DF (1992) 'Concentration and profits in South Africa: Monopoly or efficiency', *South African Journal of Economics*.
- Scherer, FN (1980) *Industrial market structure and economic performance* (2nd ed.), Rand McNally.
- Schumpeter, JA (1950) *Capitalism, socialism and democracy*, Unpin.
- Shepherd, WG (1985) *The Economics of Industrial Organisation* (2nd ed.), Prentice Hall.
- Weiss, L (1971) 'Quantitative studies of industrial organisation' in M D Intriligator (ed) *Frontiers of Quantitative Economics*, North Holland.
- Wilson, T (1952) 'Restrictive practices' in JP Miller (ed) *Competition, cartels and their regulation*, North Holland.

# 4

## Support for the Austrian theory from South African data

### **The purpose of the *Competition Act*, 89 of '98**

The Act (Section 2) has as its purpose the desire to... “promote and maintain competition in the Republic in order –

- a) to promote the efficiency, adaptability and development of the economy;
- b) to provide consumers with competitive prices and product choices;
- c) to promote employment and advance the social and economic welfare of South Africans;
- d) to expand opportunities for South African participation in world markets while at the same time recognising the role of foreign competition in the Republic;
- e) to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the economy; and
- f) to promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons.”

None of these is exceptionable. It is, however, questionable if every one of them should fall within the ambit of *competition* policy. Similarly, and derivatively, it is not clear that each of them taken together will lead to internally consistent policy advice. The general rubric “promoting and maintaining competition” implies – without further expansion being required – the promotion of criteria (a) and (b). But consider the others *seriatim*.

The promotion of employment (c) is a matter for macroeconomic, not competition policy. Employment promotion, moreover, could, if elevated sufficiently highly in a competition policy judicial decision, result in reduced efficiency (a) and prices and products (b) which consumers in competitive markets might shun. Similarly to adopt a policy to advance the (undefined) “social” welfare of South Africans might result in policies with outcomes contrary to those aimed at under (a) and (b). The desire to “expand opportunities” for export performance (d) is also not obviously a matter for *competition* policy. This is generally a matter of macroeconomic concern (for example international trade policy or exchange rate policy). Again its pursuit could result in policies and outcomes contrary to the overall objectives of (a) and (b). The aim of ensuring that small and medium-sized enterprises “have an equitable opportunity to participate” in the economy (e) is perfectly compatible with the promotion and maintenance of competition and with objectives (a) and (b) provided that such enterprises produce what consumers want (b), do so efficiently (a), and that there are no artificially imposed entry barriers preventing them or others from doing so. Under those circumstances (e) is unexceptional. The word “equitable”, however, is open to many interpretations, not necessarily fitting within the competitive paradigm of free entry. It clearly has the potential to operate perversely relative to (a) and (b). Similarly clause (f) has little place in *competition* policy. If regulations in the past have distorted ownership patterns from what they would have been, removal of socially biased legislation will result in rectification of such disparities. (Indeed a casual glance at changes in South African industrial structure and ownership in the last few years indicate that this is already occurring.) A case can, of course, be made for acceleration of redress. However, the redistributive tools should be either fiscal or involve capital reallocation via state asset restructuring. *Competition* policy is an inappropriate forum. The task of the competition authorities is difficult. To add criteria (c) through (f) to their remit may make it impossible.

The new competition policy thus combines what in other jurisdictions is often kept apart. What is more, this is likely to be worse than counterproductive. We saw earlier that the purpose of competition policy is to ameliorate the effects of the presence of the Harberger triangle. By

specifying favoured activities and groups, however, the Act is likely to encourage rent-seeking and corporate investment to capture the much larger Tullock rectangle. The long term and dynamic results of this type of legislation, discouraging productive and allocative efficiency, and so misallocating resources could be serious indeed.

#### Prohibition of restrictive practices

The Act prohibits, on a *per se* basis, both horizontal (S4) and vertical (S5) restrictive practices. In some cases the prohibition falls away if a party to the agreement can demonstrate that there are net gains resulting from the agreement due to the presence of “technological, efficiency or other pro-competitive” effects.

#### Horizontal agreements

An agreement is prohibited if (S4[1a])

- i. “it has the effect of substantially preventing, or lessening, competition in a market” or (S4[1b])
- ii. “it involves any of the following:
  - a. directly or indirectly fixing a purchase or selling price or any other trading condition
  - b. dividing markets by allocating customers, suppliers, territories, or specific types of goods or services; or
  - c. collusive tendering”.

Moreover, an agreement is presumed to exist between two or more firms if there is any “substantial” cross-holding of shares, or similar right in the other, or there is at least one director in common, and any combination of them is involved in such a restriction. The onus is on the firms (or directors) to rebut the presumption, by, for example, demonstrating that the practice is a normal custom of trade for the market in question.

Some economists might not see any immediate need to dispute S4 on horizontal agreements. The prohibition appears *prima facie* to fit within the literature on monopoly well-established by Harberger (1954), Williamson (1968) and Liebenstein (1961). Firms can come together, restrict output and raise price *as if* they were a monopoly. There is a corresponding dead-weight loss (the concern of the economist) and level of excess profits. These in turn can be extracted by managers or workers as monopoly rents received as higher salaries, wages, perquisites or other forms of X-inefficiency. If costs fall the Williamsonian trade-off can be made.

Economists, however, should bear in mind that competition authorities tend not to interpret the trade-off as one of allocative against productive efficiency as in Figure 2. That defence correctly implies that restrictive practices can be justified even though price is higher ( $P_m > P_c$ ) and output is lower ( $Q_m < Q_c$ ) with the practice than without.

A more likely interpretation is that the parties to a practice, to avoid its prohibition, must demonstrate that the cost curve has been shifted down sufficiently far for it to result in a “monopoly” price being set *below* the competitive price. Then *both* forms of efficiency are increased. In other words, there will then be no real trade-off defence in practice.

The trade-off defence, however, is only permitted for S4(1a). Agreements that fall under S4(1b) are prohibited *per se*.

At another level, some economists might dispute whether S4 is, in fact, necessary at all. Stigler (1966, p.230), has argued persuasively that such agreements are cartels: or as he engagingly puts it “they are gentlemen’s agreements, where the participants seldom are, or long do”. The underlying belief of S4 is that *pro rata* shares of profits resulting from group wealth maximising behaviour will be greater than would accrue if individualistic, but self defeating, motivations dominated. The dead-weight losses of noncontestable monopoly (lower volumes and higher consumer prices) would therefore arise.

Stigler’s view of cartels, however, is that they are either tacit or explicit agreements which, because of rivalry, seldom last. Horizontal restrictive practices are understandable but will not

persist. First, individual firms will always have an incentive to chisel or cheat on any explicit or implicit price agreement. Such cheating will be quickly noticed and responded to by competing price reductions (leading to lower non-collusive prices providing normal returns). Second, to guard against chiselling firms set up monitoring mechanisms (of each other) or allocate shares of market revenues or territories for exclusive use. This is costly to initiate and/or agreement and enforcement may be difficult. The less likely is agreement (because e.g. efficient firms do not like feather-bedding inefficient ones, each likes a “fair” share of profits and “fairness” is difficult to define) the more likely is cartel breakdown. Third, cartel breakdown by chiselling is also more likely the higher is the ratio of fixed to total costs in an industry. Given a relatively high burden of fixed costs a “voluntary” short-term diminution of the flow of cash revenues (by “agreeing” to high uniform prices and to forego chiselling) may create financial difficulties. This is particularly true either in times of market depression when demand falls; or as a corollary, during times of what Stigler called “investment rivalry”. That is, if cartel quotas are based on productive capacity, cartel members may build bigger plants to compete for larger quotas, thereby dissipating cartel profits. Finally, if existing firms do not cheat and pull prices down to lower levels, then as in any contestable monopoly, new firms will enter the industry and achieve the same result. Indeed even the threat of their entry can have this result.

Lastly, and to draw the threads of this section together, prohibiting restrictive horizontal agreements would be regarded by most as unnecessary where the parties to the agreement constitute in aggregate only a small share of the relevant market. They simply would not have the ability to raise price and reduce output as described in Figure 1. While, if a cartel agreement comprising all or most firms in the market place persists and is not unstable (absent regulatory support from government) then it may well be that there are compelling, but not immediately obvious efficiency reasons (such as lower transaction costs) for the agreement’s persistence. Additionally or alternatively, because of peculiarities on the demand side of the market, collusion may be required to ensure stable industry equilibrium<sup>1</sup>.

### **Restrictive vertical practices**

Like horizontal agreements vertical agreements are prohibited if they substantially prevent or lessen competition S5(1). Again a trade-off defence is explicitly permitted. All vertical agreements except resale price maintenance (RPM) can have that trade-off applied S5(2). A minority of economists would question that exception. Williamson, (1987, p.144) has argued for RPM as a transaction cost minimising device, particularly in cases where the manufacturer and consumer both require that the retailer provide significant input and value-added to the final product. RPM and the associated refusal to deal if a retailer drops the final price may be the least-cost monitoring device to ensure retail services are indeed provided. A *per se* prohibition without any trade-off defence potential may therefore prove to be too harsh.

Even the overall prohibition of S5 may be redundant. Most relationships within firms and many between firms are vertical in nature. Coase’s (1937) theory of the firm suggests that it is nearly impossible to define and isolate a single stage in a production process. Furthermore, the concern that one firm might selectively favour associated companies for monopolistic reasons is ill-founded in theory. Bork indicated (1993, p.228) that

“...it is impossible for a firm actually to sell to itself for less than it sells to outside firms because the real cost of any transfer...includes the return that could have been made on a sale to an outsider. No matter what the bookkeeper writes down as the transfer price, the real cost is the opportunity foregone.”

Subsidising associated firms, if it occurred, would be self-deception, involving sacrifice of returns, and merely provide encouragement to the associate to operate at an uneconomical rate. Cross-subsidisation cannot increase existing returns, nor can it enhance any above-normal or monopolistic



returns. Bork emphasises (p.229) that above-normal returns, if they do exist, can be extracted only once from the value chain.

He demonstrates this by looking at an integrated manufacturer and retailer. If each tries to maximise profit by restricting output, the result will be a self-defeating inter-company selling price higher and an output smaller than the monopoly point. Bork's rationale starts by looking at a monopoly manufacturer selling to competitive retailers. The manufacturer will set output and price so that consumers will be charged the monopoly price after retailers have added their costs, including a normal return. The manufacturer will not want retailers to earn more (since that would be foregone profit), nor will he want them to earn less, since then retail investment and so throughput would ultimately decline to the manufacturer's detriment. Similarly, if retailers earned more and so expanded, the manufacturer would be paying for unwanted retail services. If the manufacturer takes over the retail sector, the demand he faces and costs he would incur will be unchanged. His profit-maximising output decision will thus also be unchanged. There can only be one monopoly profit. Analyses of other market structures can further demonstrate this assertion. (My text with JN Crook, *Managerial Economics*, 4<sup>th</sup> ed. 1995, contains several pages of transfer pricing rules managers can apply in their own interests to maximise profits in a vertically integrated situation. They do not include favouring associated firms. Indeed, for profit maximisation, they warn against it.)

Another reason to fear vertical agreements is predation: that is, the intent to drive independent firms out of business either by a direct price war or by selling inputs to associated firms at such low prices that the associates can indulge in a price war. After a successful price war prices can be raised to monopolistic levels.

Firms so charged are allegedly making an investment today in the hope of reaping future profits tomorrow. After success is achieved (not before) prices are raised and firms start to earn a return on their investment in the strategy. The strategy is implausible. It implies non-profit maximising behaviour for as long as prices are set below the competitive level (i.e. for as long as the war lasts). This "investment" behaviour must continue long enough for rivals to be sufficiently weakened (even driven out of business) so that the original predator can now raise its price. This is costly. Time has to elapse. Further, losses have to be incurred not only on the original low priced volumes, but also on the increase in volume generated by the non-profit maximising, low prices. Not only is the "investment" time-consuming, so is the period of pay-back. The predator then has to charge a high enough price, for a long enough time to have made the exercise worthwhile. (And recall, because of discounting, the profits earned in the future are worth less than the profits forfeited today). Finally, the strategists must take into account that such monopolistically higher prices would then attract entry into, or expansion in the industry by rivals just when they hope to reap their predatory rewards. Such potential competition is just the type of price depressing rivalry which deters the predation *ab initio*.

#### Dominant firm provisions

A firm is dominant (S7) if:

- i. it has at least 45 per cent of its market; or
- ii. it has 35 per cent of its market, but under 45 per cent, and cannot show that it does not have market power; or
- iii. it has under 35 per cent of its market as well as market power.

S6 explains that the critical percentages can refer to either sales or assets of the firm and market in question. And, in addition, the authorities must stipulate in advance how, in relation to specific industries these percentages are to apply. Two definitional problems, therefore, are immediately obvious. What is an industry? Or to put it another way, what is the relevant market? And second, what significance do these percentages have? The questions begged by the words "market powers" are answered in SS8 and 9.

How should the authorities define the collection of products or firms to be studied? Clearly this will affect the conclusions. Industries can be defined from a *technological* stance or a *consumption* stance. They can be assessed at a high *level of aggregation* or a low. When the economist defines an industry technologically he does so by specifying a group of products between which there is a high *cross-elasticity of supply*. Two firms would be in the same industry if the resources of the one could be readily transferred to producing the products of the other. Thus firms in the footwear industry would be competitors by this definition. Yet if the level of aggregation was changed to canvas and leather footwear and the two firms were found to operate respectively in these submarkets, should supply cross-elasticity still be considered as an appropriate competition proxy? Alternatively, even at the same level of industry aggregation, is there really high cross-elasticity of supply between a Ford and Toyota? To the customer they are alternative products, but to retool the Ford factory to produce Toyotas would be prohibitively expensive.

An alternative is to use *cross-elasticity of demand*. The more acceptable are substitutes to consumers in the market the higher is the index. The relevant market or industry to examine is that group of firms or products between which the cross-elasticity is high. Two brands of instant coffee are in the same industry (even though one might be produced by a spray-drying technique and the other by the very different freeze-drying technology). Moreover, are not tea, beer and cola substitutes for coffee? And, in recent years with tariff liberation, even if one firm in South Africa controls all domestic production, does it matter to the consumer if there is a choice available that includes competitively priced imports?

The problems are immense, and are not necessarily overcome by the statistics available from official government sources that tend traditionally to have been collected on a basis of 'what is practical' rather than 'what is desirable'. This is less true of commercial market research data that cater for fee-paying clients interested in direct competition. In the 1970s the US Federal Trade Commission experimented with 'Line of Business' data to supplement the traditional Standard Industrial Classifications and to overcome the problems discussed above. That series was discontinued in the early 1980s.

Asch (1983, pp.168-9) crystallised the difficulty by emphasising that consumer substitutability is the key for defining the market as it currently stands, but that since conduct depends also on potential entry, then producer substitutability must also be taken into account. These 'criteria can be extremely difficult to satisfy simultaneously'. Moreover, he argues, if markets are defined too broadly, concentration measures may misleadingly understate the true situation. If they are defined too narrowly then concentration may appear overwhelming.

Even that is not the end of the story. Part of the aggregation problem and resulting understatement: overstatement difficulties reflect the fact that different firms are more dominant in some submarkets than others. The sub-markets of a given industry can themselves differ widely in their unit or value size but may or may not have demand side competitive inter-relationships (e.g. trucks, cars and motorcycles are only rarely regarded by consumers as substitutes). But they are all produced in the automotive industry and competitive cross-entry by suppliers from one sub-market to another may be relatively easy.

The correct approach is not to opt for the narrowest or broadest market definition. But rather to examine the most appropriate definition of the relevant market for the case at hand. Given the position of adversarial advocacy necessarily adopted by opposing lawyers at competition authority hearings, it becomes ever more important that economists determine the appropriate emphasis to be laid on either the supply or demand side of the market, and in turn the appropriate level of aggregation.

The market figures in S7 of the Act of 45 and 35 per cent, are themselves of course, arbitrary, and while the existence of a high share is not prohibited, there is at least an implied presumption of "guilt" based on the disputed Structure: Conduct: Performance paradigm of industrial economics. The theory underlying that model has been disputed by myself (1984) and its empirical validity has been cast open to doubt in South Africa and elsewhere (Leach, 1997). There are still some South African writers (Fourie and Smith 1998) who claim the results suggest that dominance leads to

abuse. The Leach evidence suggest that it is efficiency or scale which leads to customer attracting dominance, or to large asset bases being required for the efficient servicing of a relatively small local market.

Be that as it may, the Act continues by providing its own definitions of “abuse” of dominance. In S8 the abuses prohibited *per se* include an “excessive price” charged “to the detriment of consumers”. This is clearly monopoly behaviour in terms of the Harberger triangle. S8(b) prohibits refusal to supply to a competitor “access to an essential facility when it is economically feasible to do so”. This prohibition is difficult to understand. It would seem, for example, to nullify property rights in patents or other proprietarily achieved facilities. There is little to indicate that this deficiency is appreciated in the Act.

SS8(c) and 8(d) prohibit any “exclusionary acts” unless gains in efficiency, technological or pro-competitive effects outweigh the “anti-competitive effect” of the exclusionary act. Again this is likely to be interpreted as a stricter requirement than the Williamson trade-off of Figs 1 and 2, which would accept a price,  $P_m$ , higher than  $P_c$ . In addition to the prohibitions, the Act introduces for the first time in South Africa (in S62) the possibility of divestiture in cases of dominance. This draws on American antitrust legislation for a precedent. It has been little used in the USA (since World War I, only in the Bell Telephone case in the early 1980s). It will probably be little used here. As noted earlier, “unbundling” is a common voluntary feature of current South African industry. That deconcentration process is currently reversing the legislation-induced concentration of the *apartheid* years when indigenous firms found it difficult to expand overseas, and instead found it easier to acquire the assets of disinvesting multinationals. Concern over South African concentration may have been legitimate. The inclusion of a divestiture penalty in the new Act, however, suggest its causes may not have been fully understood. (In fact, the Bell Telephone, or AT&T case, of the 1980s was closer to a deregulation/privatisation exercise, liberating a previously highly regulated public utility, than it was to a conventional antitrust judgement).

### **Price discrimination by a dominant firm is prohibited (S9)**

This (S9) is one of the more surprising prohibitions of the entire Act since it is drawn (legally) from a largely, redundant and unused American act: the Robinson-Patman Act of 1936. It also contradicts much of economic theory, which by-and-large looks at price discrimination with approval. Two reasons can be proffered for this surprising prohibition.

First, as with Robinson-Patman, there are powerful vested interest groups who have lobbied in its favour. (Scherer (1997), cites, for the USA, small scale retailers in foodstuffs and pharmacy). Both of these gradually succumbed to competitive forces as supermarkets and multiple chain pharmacies grew in importance in America. In South Africa exactly the same two lobby groups approached the old Competition Board to protest against discriminatory pricing. (*Report No.4* gives an excellent analysis of the economic case for discriminatory pricing – in response to complaints from small scale food retailers; *Report 34*, conversely, supported the complainants, small scale pharmacists. Economists wrote the former Report; the latter Report was unsigned.)

A second reason why price discrimination may have received this surprise prohibition is that the phrase is a technical term. Economists have frequently made themselves hostages to policy fortune by using terms with specific technical meanings which, to the lay person are value laden (e.g. perfect competition, inferior goods, and discriminatory pricing). If racial, religious or sexual discrimination is “wrong” then is not price discrimination also? In the Act price discrimination is defined broadly and simply as different prices to different customers, for “equivalent transactions” (S9.1b). A technical definition would define the price differences relative to costs.

Scherer (1997) points out that it is difficult to ascertain – without empirical data – whether price discrimination harms the interest of the final consumer. Economists have used an emotive adjective for a technical situation. Just as ‘perfection’ in competition should not necessarily be seen as desirable – it describes market characteristics – neither should ‘discrimination’ in price automatically be regarded negatively. It simply means that non-identical price : marginal cost ratios

are set when a firm sells products to different market segments. Whether this is welfare enhancing is dependent on the case.

Price discrimination should not be immediately regarded as pejorative. First, since monopolistic abuse generally implies lower outputs then it is not necessarily true that price discrimination has resulted in an inefficient outcome. It can be shown theoretically that price discrimination often results in increased (or at least unchanged) total outputs).

Joan Robinson made this point in 1933 (p.206) stating that,

“...price discrimination must be held to be superior to (non-discrimination) in all these cases (the more common) in which it leads to an increase in output...”.

Of course, static or increased output levels are not enough on their own to remove ambiguity about the impact on welfare. After all the price differences result in reduction of consumption by high valued users and increased consumption by low valued users. The welfare gains from the increased consumption of the latter must be sufficient to offset the losses of the former before unqualified approval can be given.

In addition, of course, equity might have improved since more price sensitive buyers might now have been drawn into the market. Robinson (p.204) also noted these desirable equity implications of price discrimination.

“(M)embers of the more elastic market (for whom price is reduced) may be poorer than members of the less elastic markets, and we may consider a gain to poorer buyers more important than a loss to richer buyers.”

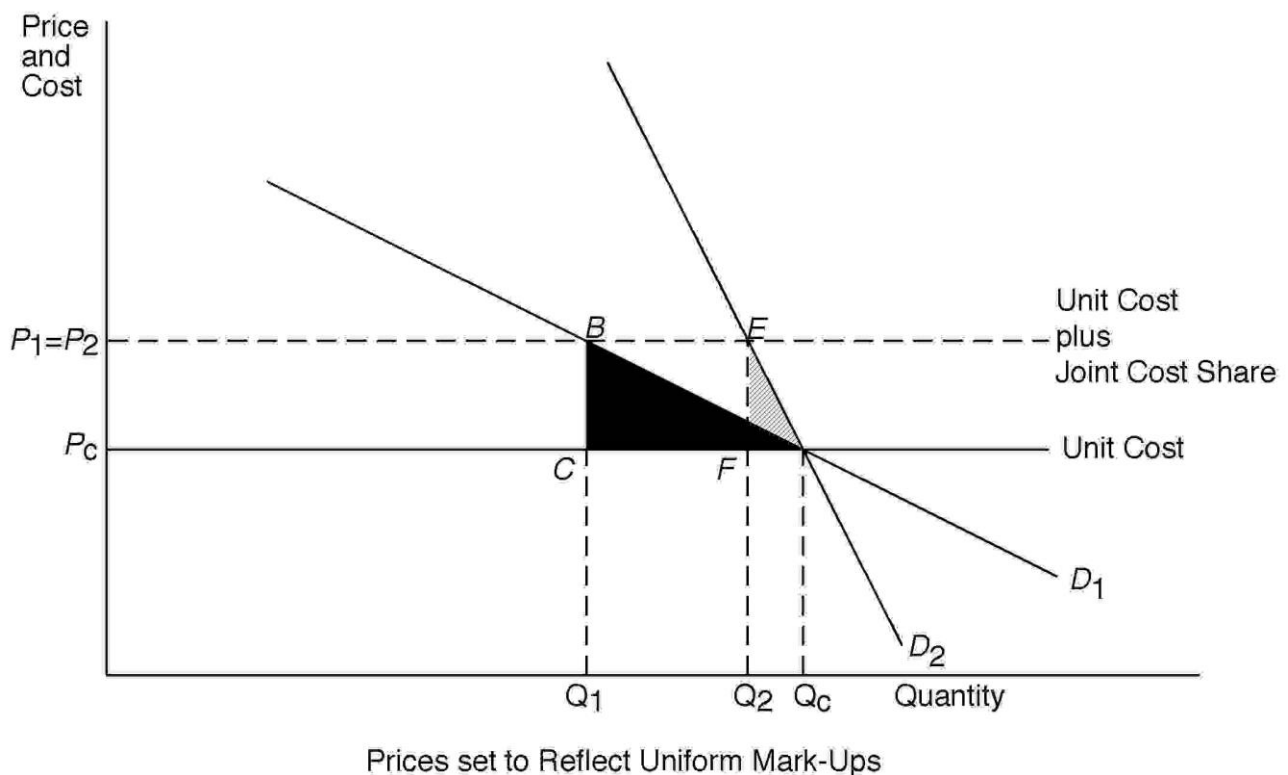
As noted by Robinson, however, this outcome is not of relevance to the *economic* theory of competition. But given that the writers of the 1998 Act have redress to the previously disadvantaged as an objective of competition policy, it seems perverse to prohibit a practice that can be both pro-competitive and redistributive in effect.

A second set of arguments in favour of price discrimination is that it results in producers appropriating additional consumers' surplus. This may be a prerequisite if the product is to be produced *at all*. As with Dupuit's Bridge, where short-run marginal cost is zero – a *non*-discriminating, toll-charging monopolist might consider building to be a bad investment. Analogously, price discrimination may be necessary, *inter alia*, to permit firms to recoup their research and development or other overhead or joint costs. (A simple but not simplistic, illustration is the wide range of prices charged on a long distance aircraft. The joint – or fixed – costs of the capital outlays on the aircraft itself must be recouped. But some passengers will pay a fare close to the short run marginal cost of the fuel alone, e.g. those on stand-by tickets. A whole range of prices through tourist class, business class and first class is then charged according to passenger elasticity of demand or willingness-to-pay.)

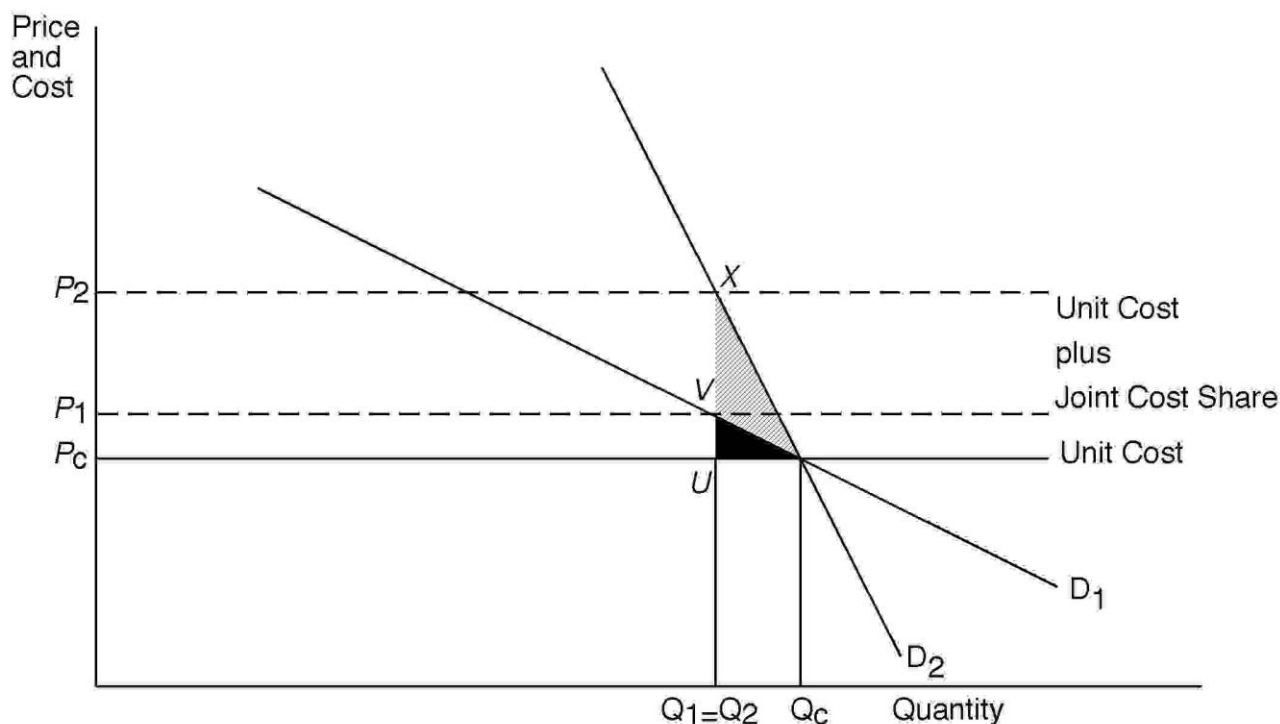
One could ask the normative question, how *should* such common costs be recovered? There are three possible answers. A regime of either uniform pricing, Ramsey pricing or spontaneous price discrimination could be adopted. The first two could be imposed by regulation. With a uniform mark-up on short-run marginal costs, overheads could indeed be met. Given different demand elasticities, however, the reduction in quantity demanded would be greater with the more price sensitive product or segment. The total dead-weight loss is then substantial. (See Figure 5, where  $P_c$  equals short run marginal cost. The rectangles  $P_1C$  and  $P_2F$  in aggregate represent the overheads that *must* be recouped from the two market segments if production is to take place *at all*.) But if a situation of Ramsey pricing is imposed, the same value of common costs can be recouped although the mark-up must be greater where demand is relatively price insensitive). The optimal, minimum overall dead-weight loss situation is then achieved. (In Figure 6 rectangles  $P_2U$  plus  $P_1U$  are constrained to equal in area the overheads recovered in Figure 5 from areas  $P_1C$  plus  $P_2F$ .)

Ramsey pricing implies that the ‘inverse elasticity’ rule is followed. To cite Baumol and Bradford (1970, p.267), “each price should be set so that its percentage deviation from marginal cost is inversely proportionate to the item’s price elasticity of demand”. That is the ratio  $e_1/e_2$  should equal  $Z_2/Z_1$  where elasticities are denoted by  $e$  and mark-ups by  $Z$  (where  $Z = (P-MC)/P$ ). Unfortunately this optimal rule will tend not to be followed. Even if the cost and demand data were available it is doubtful if any regulatory body would so employ them. High demand elasticity generally means ready availability of substitutes. Low demand elasticity, conversely, tends to mean that people who want a certain product have few alternatives available and/or regard the product as a ‘necessity’. When this is the case vocal objections to a relatively high price are likely to be raised (which again is a reason why anti-price discrimination laws find their way so readily, if inappropriately, onto the statute books).

**Figure 5**



**Figure 6**



Prices set to obtain equiproportional quantity reductions

An unregulated profit-maximising firm, however, will adopt *spontaneously* a pricing scheme at least qualitatively similar to the socially optimal one. In the short run, common or overhead costs will be regarded as sunk and the firm will set marginal revenues equal to marginal cost for all products. The outcome of spontaneous price discrimination for a two product or two market segment firm can then be shown to be  $(1 + e_1)/(1 + e_2) = Y_2/Y_1$  (where Y is the price: marginal cost ratio  $(P-MC)/MC$ ). This is not the same as Ramsey optimality. (Y is spontaneously determined, ignoring sunk costs and aimed at profit maximisation; Z is set to optimise constrained cost recovery). But the ratio is certainly closer to Ramsey optimality in terms of dead-weight losses which *must* be sacrificed to cover common costs than is the frequently observed legislative alternative of a ban on discriminatory prices.

John Bridgeman, the UK's Director General of Fair Trading (who will have the responsibility of interpreting Chapter II of the UK's new Competition Act – which is very similar in wording to both Article 86 of the Treaty of Rome, and also the S.A. Act 89 of 1998) noted, in reply to a lecture by Professor John Vickers, who had also made this point about differential mark-ups:

“...we need to judge price discrimination in terms of economic effect rather than form. Indeed, this is generally applicable across the wider spectrum of competition.” (Bridgeman, 1998, p.199)

## Exemptions from the restrictive practice and dominance prohibitions

### Vertical and horizontal agreements

The Act prohibits both vertical and horizontal agreements (unless there are technological, efficiency or other pro-competition gains). Exemption from these bans can be granted under S10(3) provided that the agreement “contributes to any of the following (S10[3b]):

- i. maintenance or promotion of exports;

- ii. promotion of the ability of small businesses...controlled or owned by historically disadvantaged persons, to become competitive;
- iii. change in productive capacity necessary to stop decline in an industry; or
- iv. the economic stability of any industry” (so designated by the authorities).

Points (i) and (ii) have already been discussed above. Points (iii) and (iv) are quaint and again are irrelevant to competition policy designed to promote the efficiency, adaptability, and development of the economy. Arresting or alleviating the impact of structural industrial decline or instability may be appropriate social objectives of government, but they are not the concern of competition authorities. And, of course, all four exemptions open the door for welfare reducing, rent-seeking behaviour, which will be worth engaging in up to the extent of the Tullock rectangle.

### **Price discrimination exemptions**

To be exempt from the *per se* prohibition of price discrimination the dominant firm must be able to establish that the differential treatment: (S9.2)

- a. “makes only reasonable allowance for differences in cost or likely cost of manufacture, distribution, sale, promotion or delivery resulting from the differing places to which, methods by which, or quantities in which, goods or services are supplied to different purchasers;
- b. is constituted by doing acts in good faith to meet a price or benefit offered by a competitor; or
- c. is in response to changing conditions affecting the market for the goods or services concerned, including –
  - i. any action in response to the actual or imminent deterioration of perishable goods;
  - ii. any action in response to the obsolescence of seasonal goods;
  - iii. a sale pursuant to a liquidation or sequestration procedure; or
  - iv. a sale in good faith in discontinuance of business in the goods or services concerned”.

The exceptions involve difficulties and illustrate further problems with the prohibition itself. First, recall that price discrimination has both a legal definition (that of the Act) and a technical definition (non-proportionality to marginal costs).

We have already seen how price discrimination can increase both output and increase equity. Both definitions show also that price discrimination is identified by examining ratios (price : cost), not by examining price alone. Thus identical prices can be discriminatory if costs differ. This is why exception (a) above is necessary.

The Act accepts that differences in price are not to be prohibited if they result from “differences in cost or *likely* cost” (my emphasis). The policy problem here is that costs are subjective. When the manager of a firm takes a decision only he/she knows the benefit he/she is foregoing – the cost – of the decision. Hence the use of the adjective “likely”. To illustrate one difficulty with uniform prices for equivalent transactions, ask “what is equivalent?” A manufacturer may wish to raise his share of the market. Should he price at the same level today to two different distribution channels if he anticipates one channel has a much higher growth potential tomorrow? If he believes the one channel has a more efficient (lower cost) method of reaching the consumer and can expand more rapidly tomorrow than the other channel, how can he encourage that for his own (but also the final consumer’s benefit? The answer is to price *ahead of demand* by lowering price to the channel with high potential – a common business practice but one with *prima facie* evidence of unjustifiable price discrimination. Yet closer inspection, taking account of *likely* costs, might render any price differences “justifiable”.

A careful reading of the Act reveals that it *follows US legislation almost word for word on the issue of price discrimination*. This is a pity since most US economic commentators are dissatisfied with their own law. The two main pieces of US legislation referred to (and drawn on by the South African Act) are the Robinson-Patman Act 1936 and the 1914 Clayton Act which prohibited price discrimination which ‘substantially’ lessened competition or tended ‘to create a monopoly’. The Clayton Act excluded from this prohibition discrimination owing to differences in grade, quality or

quantity of the goods sold; discrimination which makes 'due allowance' for differences in cost; and third, discrimination 'carried out in good faith' to meet a competitor's price. Small traders were not protected since the quantity clause provided an easy escape. Moreover the courts refused to apply the law when the discrimination resulted from the pressures of large traders on their suppliers. These issues became increasingly apparent with the advent of large-scale retailing during the 1920s and 1930s. The Depression coincided and the problems of small and medium-sized buyers were compounded by the tendency of manufacturers to shade prices and give less than overt rebates in the face of declining demand. The trend towards government approval of cartelisation at that juncture of history was embodied in the National Recovery Administration in the USA and the Robinson-Patman Act was passed against that background.

The main purpose of the Act was to prevent powerful retailing groups from obtaining 'undue' favours from their suppliers relative to small- and medium-sized traders. It prohibits the charging of different prices to different purchasers of 'goods of like grade and quality' if the effect 'may be substantially to lessen competition or tend to create a monopoly...or to injure...competition'. Another section renders it illegal for a buyer 'knowingly to induce or receive a discrimination in price'. As with the new South African Act any refunds allowed relate to perishability, obsolescence, 'due allowance for differences in the cost...resulting from the differing methods or quantities' specific to the transaction in question, and/or that it was done 'in good faith to meet an equally low price of a competitor'. Neale (1960, pp.252-3) summarises the case law history of *Robinson-Patman's* application as follows:

[it] will be met with frank unbelief. The idea that a manufacturer may break the law by granting a wholesaler's discount to a wholesaler who also runs retail shops, or by selling goods direct to retailers at a price higher than one of his wholesalers may be charging, or by beating an offer made to an important customer by a rival manufacturer or even by matching the offer unless he is satisfied that his rival can justify his low price by cost savings...may simply seem incredible.

But that is the US law and it is now being copied by the South African Act. The muddle is inevitable given the conflicting objectives of Robinson-Patman. It attempts to protect small business against price disadvantages on the one hand, while simultaneously attempting to combat price discrimination as anti-competitive.

The difficulty US industry has with the law is illustrated by the 'good-faith' price-matching defence. To succeed, the seller must show that the matched price is itself lawful. This necessitates knowledge of the competitor's own price and cost structure – but in a classic Catch-22 if he shows he has such knowledge he may be prosecuted for conspiring to restrain trade under the Sherman Act, (or in South Africa – entering into a prohibited horizontal agreement). Further confusion is caused in the legislation (American and South African) by failure technically to define price discrimination: disproportionality of price: marginal cost ratios. Thus identical prices with different costs (uniform price discrimination) would be difficult to attack by either legislation.

In 1980 the US Department of Justice recommended repeal of Robinson-Patman, as well as the section of the Clayton Act which it had amended. But to date this has not happened. In the interim it has largely fallen into disuse but prior to 1980 it certainly had anti-competitive effects by deterring firms from engaging in selective price-cutting (which is one main reason why economists argue cartels cannot survive absent government regulatory support). Essentially the Robinson Patman Act and the South African Act both protect particular competitors, rather than competition.

## **Merger control**

A merger occurs (S12) if one or more persons acquire "direct or indirect...control" over "significant interests in the whole or part of the business of a competitor, supplier (or) customer...". Further (restrictive) amplification of this definition is provided. "Control" is defined to include ownership



of, or the ability to vote a majority of the relevant shares. It also includes “the ability to materially influence the policy of the firm” as if majority control was held.

Notification of proposed or accomplished mergers must be made, not only to the competition authorities but also to relevant employees or trade unions. The Act will apply to all mergers above a variable and pre-determined threshold of turnover or asset size. The authorities (S15) must then approve, or approve with conditions, or prohibit the notified merger.

When assessing a merger (S16) the authorities must ascertain whether it “is likely to substantially prevent or lessen competition”. And further, they must judge whether there will be any net “technological efficiency or pro-competitive” gain. So much fits well within the framework of Figures 1 and 2 above.

When determining whether or not a merger or proposed merger is likely substantially to prevent or lessen competition, the authorities must assess the strength of competition in the relevant market, and the probability that the firms in the market after the merger will behave competitively or co-operatively, taking into account “any factor that is relevant to competition” in the market, including (S16.2)

- i. “the actual and potential level of import competition in the market;
- ii. the ease of entry into the market, including tariff and regulatory barriers;
- iii. the level, trends of concentration, and history of collusion, in the market;
- iv. the degree of countervailing power in the market;
- v. the likelihood that the acquisition would result in the merged firm having market power;
- vi. the dynamic characteristics of the market, including growth, innovation, and product differentiation;
- vii. whether the business, or part of the business, of a party to the merger or proposed merger has failed or is likely to fail; and
- viii. whether the merger will result in the removal of an effective competitor”.

In short, in addition to the difficulties of assessing current dominance, the authorities will have added to their brief the very difficult (if not impossible) task of assessing how the competitive situation could evolve in future. Point (vii), the so-called “failing company” defence for a merger typifies the problem. When has a company “failed enough” to justify use of the defence? Subsequent to bankruptcy and liquidation is clearly inappropriate, but prior to that the scope for judgement is not necessarily narrow. Mergers can be regarded as an efficient alternative to bankruptcy and voluntary liquidation. But, especially if a large firm is doing the acquiring, the *prima facie* reason will often appear to regulators to be one of merely increasing market power.

### **The public interest**

Under S16(3) mergers can also be justified on “public interest grounds”. Here the authorities must consider the effect the merger will have on:

- i. “a particular industrial sector or region;
- ii. employment;
- iii. the ability of small business, or firms controlled or owned by historically disadvantaged persons to become competitive; and
- iv. the ability of national industries to compete in international markets”.

The scope for error, flexible interpretation, and subjectivity of judgement seems great. Prospective local or foreign investors could then well be deterred from take-over activity if there are to be unknown and unpredictable reactions by the new authorities. These reactions in turn will be influenced by successful rent-seekers. A brake on appropriate investment or an acceleration of the inappropriate course then perversely affects the stated objectives of the policy. That could adversely affect exports, corporate tax revenue, and hamper possible spin-off demand for the products of small and medium scale enterprises. A second problem with the definition of the “public interest” is what it *includes*. The socio-economic objectives incorporate redistribution, labour interests and

black economic empowerment. Relying on competition policy to achieve these objectives is inappropriate. There are more specific (and hence more effective) policies that can be used. As already noted overall welfare is greatest when society's resources are allocated in the economy so that consumers are able to satisfy their wants as far as technological and physical constraints permit. In this way the wealth of the nation is maximised. Competition policy's aim should be to help bring about this result. When government wishes to achieve other objectives (e.g. to redistribute income or wealth, to promote the interests of historically disadvantaged groups or to encourage structural, regional or national organisational changes) other policies should be applied. Anti-trust authorities may note such goals, but they are in the bailiwick of other agencies.

<sup>1</sup> In *FMF Occasional Paper No.3* this is explained with regard to S4(1b) as it could relate to the diamond industry.

## References

- Asch, P (1983) *Industrial organisation and antitrust policy*, Chichester: John Wiley.
- Baumol, WJ and Bradford, DF (1970) "Optimal departures from marginal cost pricing" *American Economic Review*, Vol.60, pp.265-83.
- Bridgeman, J (1998) Comment on John Vickers, "When is discrimination undue?" in ME Beesley (ed), *Regulating utilities: Understanding the issues*, Institute of Economic Affairs, London.
- Coase, RH (1937) 'The nature of the firm', *Economica*, Vol.14, n.s., pp.386-405.
- Competition Board, Report 4, (1981) *Investigation into discrimination in respect of prices or conditions of sale*, Government Printer, Pretoria.
- Competition Board, Report 34 (1991) *Investigation into the distribution of medicine available to the public on prescription by manufacturers in pharmaceutical producers*, Pretoria.
- Dupuit, J (1969) 'On the measurement of the utility of public works' in KJ Arrow and T Scitovsky (eds), *Readings in welfare economics*, London: Allen and Unwin.
- Fourie, FCv and Smith, A (1998) 'The concentration-profits stalemate I: Causality and interpretation problems' *South African Journal of Economics*, Vol.66, pp.558-83.
- Leach, DF (1997) 'The concentration-profit monopoly vs efficiency debate: Some new South African evidence', *Contemporary Economic Policy*, Vol.XV, pp.12-24.
- Neale, AD (1960) *The antitrust laws of the USA*, (Colchester: Utrecht).
- Reekie, WD (1984) 'The Structure : Conduct : Performance paradigm in a South African setting' *South African Journal of Economics*, Vol.52, pp.146-56.
- \_\_\_\_\_ and Crook, JN (1995) *Managerial Economics* (4th ed), Prentice Hall.
- Robinson, J (1933) *The economics of imperfect competition*, Cambridge University Press.
- Scherer, FM (1997) 'How US antitrust can go astray: The brand name prescription drug litigation', *International Journal of Business and Economics*, Vol.4, pp.386-401.
- Stigler, GJ (1966) *The theory of price*, 3rd ed. New York: Macmillan.
- Telser, L (1960) "Why should manufacturers want fair trade?" *Journal of Law and Economics*, Vol.3, 86-104.
- Weiss, L (1971) 'Quantitative studies of industrial organisation' in MD Intriligator of (ed) *Frontiers of Quantitative Economics*, North Holland.
- Williamson, OE (1987) *Antitrust economics*, Basil Blackwell, Oxford.

# 5

## Conclusions

One crucial issue and a further subsidiary issue have been at stake in the South African antitrust debate in the last few years. The first is the broad question of principle that economists have been debating to and fro for several decades: what role should competition policy play in an advanced market economy? The subsidiary issue is whether South African policy should differ from policies in force elsewhere?

### Three approaches and two world views

Three disciplines are normally drawn on in drafting responses to these questions and hence competition policy itself: economics, law and politics. Economic liberals argue that markets are better than governments at curbing monopoly power. Interventionists on the other hand, reckon that vigorous efforts are required to spur competition and curb excessive market power: well-functioning markets require active competition policy. Table 1 summarises this polarity and also encapsulates our discussion of the preceding chapters. On dominant firm and merger policy, liberals give credence to the flow of causation from  $P \rightarrow C \rightarrow S$  while interventionists would tend to see the flow of causation run from  $S \rightarrow C \rightarrow P$ . (This writer's view, given the evidence, is of two-way causation, but with an emphasis on  $P \rightarrow C \rightarrow S$ ). The interventionist sees horizontal or vertical agreements as anti-competitive restrictive practices. The liberal views agreements as business practices aimed at maximising profits (which implies at the very least, the possibility that they are exercises aimed at reducing costs – or obtaining revenues from an optimal customer mix).

Lawyers have also responded to the question of the role of antitrust in the economy with two broad-brush answers. Very large firms (once defined) and agreements between firms (once defined) should be deemed illegal and prohibited *per se*. This view has been arrived at in various jurisdictions both without and with the aid of economic analysis. Lawyers have also adopted the contrary view (also with and without economic support) that the law and its interpretation should be based on the “rule of reason” and that case-by-case analysis is appropriate, not *per se* prohibition of defined market structures or corporate arrangements.

The economic liberal could tend to favour the latter approach. The interventionist might favour the former. But the overlap would certainly not be complete. Interventionists may prefer legal and economic discretion, while liberals could argue for predictability.

Politicians, likewise come to competition policy with two differing world views. It is there that the subsidiary question as to whether South African policy should be different is most frequently posed. Politicians, here and elsewhere, are subject to conflicting pressures from voters and vested interest groups. They consequently often succumb to designing or interpreting competition policy very widely. Economic liberals and economic interventionists would both deprecate this. Liberals would see additional objectives as unnecessary in any event. Interventionists would see them as better addressed by appropriate specialist legislation with the inevitable conflicts resolved by politicians. Both sets of economists would warn against the introduction of yet more opportunities and incentives to rent-seek, with resulting welfare losses *definitionally* above those of any monopoly (Figure 4). The *raison d'être* of policy they would say is the consumer.

Table 1 summarises this discussion.

**TABLE 1: Competition policy:  
Three approaches to two alternative worldviews**

<b>ECONOMICS</b>	a.	S→C→P productive and allocative inefficiency	clear cut restrictive practices
		<b>OR</b>	<b>OR</b>
	b.	P→C→S e.g. innovation, low costs and consumer satisfaction	studies of how transaction costs are minimised
<b>LAW</b>	a.	<i>Per se</i> prohibitions Presumptive illegality	
		<b>OR</b>	
	b.	'Rule of reason' case-by-case analysis	
<b>POLITICS</b>	a.	Multiple and/or conflicting objectives	
		<b>OR</b>	
	b.	Single objective – the consumer	

### Conclusions

The discussion and appraisal of the 1998 Act in Chapter 4 is summarised in Table 2.

The new Act, on the one hand contains criteria which are not relevant to competition policy and, on the other, includes selective currently politically correct or journalistically attractive targets such as “international competitiveness”. This will encourage uncertainty as to future interpretation. At the pure competition policy level it will trigger off investigations on a structurally defined basis of market share or firm size, and will result in bans on agreements, or activities which will be presumed illegal until a justification is provided after the *per se* prohibition.

The Act fails the test of legal predictability because of these inclusions. As the leading structuralist, antitrust economist Joe Bain (1968, p.512) put it:

“...the application of the law, in the sense of discovery, identification, and treatment of firms or industries that are in violation of its provision, should be predictable, impartial, and so far as possible relatively automatic – as distinct from being unpredictable, discriminatory, capricious or heavily influenced by administrative discretion.”

**TABLE 2: The Competition Act: A one sheet critique**

<b>Purpose of Act</b>	<b>Justified by Economic Theory of Competition</b>
Promoting competition (prices, efficiency).	Yes.
Other economic objectives (employment, growth, small firms).	Not relevant and conducive to rent-seeking.
Social objectives (promote historically disadvantaged, welfare).	Not relevant and conducive to rent-seeking.
<b>Horizontal Agreements Banned</b>	Yes.
Exceptional trade-offs (competition, efficiency) for S4(1a).	Yes.
No trade-offs for S4(1b).	No.
<b>Vertical Agreements Banned</b>	Debatable.

Exceptional trade-offs (competition, efficiency). RPM.            Debatable.	Yes.
<b>Abuse of Dominance Banned</b> e.g. price, output. Refusal to grant access to facility. Exceptional trade-offs (competition, efficiency). Trade-offs applied to exclusionary acts (competition, efficiency).	Yes. Property right problem. Yes.  Yes.
<b>Price Discrimination by Dominant Firm Banned</b> Exception for cost or <i>likely</i> cost differences. Exception if matching a competitor.  Exception if market conditions change.	Debatable. Yes. Yes – but breaches horizontal ban. Yes.
<b>Exemptions</b> Promoting exports, promoting small business, the historically disadvantaged, halting industrial decline. Promoting stability of designated industry.	Not relevant and conductive to rent-seeking. Debatable.
<b>Mergers</b> Prohibited if competition lessened. <i>Guidelines:</i> impact on concentration; potential of bankruptcy; ease of entry; countervailing power; innovation and dynamism; nature of vertical integration.  <i>Public interest justification:</i> impact on sector or region, small business, employment, historically disadvantaged issues, national champion issues.	Yes. Debatable. Yes. Yes. Yes. Yes. Debatable.  Not relevant and conducive to rent-seeking.

When the Act moves from ill-defined, non-pertinent objectives towards promoting competition, it again errs. It heads towards a prescriptive, structural or behaviourist *per se* prohibitive stance. In other words, it displays inappropriate understanding of how competition should be assessed. Competition is all about surprise. Its essence is that entrepreneurs do the unpredictable when meeting consumer requirements. Presumptions and definitions may simply exclude, before the event, behaviour which, after the event, would be seen as competitive. In the short run this damages competition, in the long run it reduces national wealth. Investment by local or foreign firms is discouraged.

These arguments have clearly received little weight in the writing of the Act. Investors are not left with the notion that a competitive environment will be fostered around them. Rather they are being told that meeting a plethora of “public interest” criteria will be expected, and that any novelty and entrepreneurship which lies outside of predetermined acceptable practices or structures might well be prohibited.

What is required is not the impossible (and undesirable) – namely that all aspects of monopoly control should be expressed in universally applicable laws and regulations. Rather the aim should be confined to promoting competition. A sustained effort to building up a coherent body of decisions and of guidelines for them should be made. This will give assurance of as much consistency founded on economic analysis and experience as can be made. In effect little

amendment of the original 1979 Act would have been required. Even the previous Competition Board's view of concepts such as the "public interest" occurred seldom in the old legislation but rather accumulated over the years in *Annual Reports*. If these views are correct they would have stood, if not they would have depreciated in the face of later economic arguments. Inconsistency in judgement can be corrected. Inappropriate drafting of inflexible presumptions cannot. A disappointment, as noted throughout this discussion, is the Act's use of broad economic terms such as "net gain" or "discrimination" without rigorously defining them in terms of received literature.

A reliance on economics is not the approach adopted in the Act. A massive bureaucracy of some one hundred professionals (lawyers, accountants and economists) plus support staff is being put in place. Concern for the consumer is but one of many objectives laid down for this army of social engineers. Rent-seeking will become rampant outside and be encouraged from inside this new and enormous bureaucratic empire.

Government (and business) resources could have been put to better use examining anti-competitive structures and practices in state-protected industrial or professional environments (including the nationalised industries, trade unions, and parastatals)

Instead S3, relating to the Act's scope of Application, excludes these already state-protected entities while explicitly listing again those who are to be especially favoured by the Act's purpose and its social objectives.

Two world views are in tension: equality of outcome versus equality of opportunity. Judge Bork emphasised (p.422) that a competition policy that opts for openness of markets reflects the ideal of equality of opportunity. A structuralist approach to anti trust, with *per se* declarations of behavioural illegalities is more concerned with the small and less efficient, i.e. it shows a bias towards equality of outcome. Economic rigour, however, demands that policy concern itself with the economy's smallest unit of all, the individual consumer and his or her welfare.

## **References**

Bain, JS (1956) *Industrial organisation*, Wiley, New York.