The shaky foundations of competition law

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undermines the theories on which competition law rests

The purpose of competition law in New Zealand is "to promote competition in markets for the long-term benefit of consumers". (Commerce Act 1986, s 1A) In other words, it is believed that markets left to their own devices, without any regulation of prices, quantities, or structure, could (in some cases) be harmful to consumers. The risk for consumers is such that a regulatory body, the Commerce Commission, is necessary to make sure that market participants always take into account the benefits to consumers in their decisions. This view rests on the idea that competition is a state of affairs that must be regulated and managed by the authorities because undesirable situations of monopoly can emerge all the time.

The purpose of this paper is threefold:

(a) to show that the Commerce Act rests on a mistaken view of competition;

(b) to explain the nature of (true) competition, and

(c) to expose the real face of competition law by showing that it cannot achieve the aim it is supposed to achieve (ie to correct market outcomes so as to make sure producers' decisions always benefit consumers).

At the end of the day, the problem assumed by competition law is only exacerbated by regulation, while economics shows that the entrepreneurial process solves it. So while there may be situations where competition law may seem warranted, in fact there is no crime at the crime scene. While competition law aims to protect consumers, the danger is that it may affect the self-correcting properties of the market system — an outcome worse than the disease it tries to cure.

THE THEORY BEHIND COMPETITION LAW

Since the 1930s, the "modern" view of competition in economics is that of a static state of affairs. Such a situation exists when neither producers nor consumers can individually influence the final result of the market. This implies that every entity (firm or individual) is a price taker and that prices are parametric. Moreover, no profit can ever be made as the ultimate condition of competition is that prices, marginal cost, and average cost are all equal. There is perfect harmony of interest between producers and consumers because no one can produce less than what is desired and all the factors of production (especially labour) are exactly compensated for their respective contribution in the production of the final consumption goods. In other words, the producer is "forced" as it were by consumers to produce until the cost of the last unit made is equal to the price on the market (ie the firm turns no profit on its last unit). Indeed, the firm cannot stop producing before that point, as there would still be some positive revenue to be made and it cannot produce beyond that point as it would start losing revenue on each unit it produces. Moreover, because of the forces of competition, if a firm has a cheaper production structure than others, any input it uses will be bid away by other firms such that its average cost will rise to the point where it equals the marginal cost and the price, thereby squeezing out any profit entirely. The theory stipulates that in order for this situation to be effected, a large number of producers and consumers are required and final goods must have certain properties (such as non-differentiation) so as to make the price-taking assumption viable.

According to this view, any situation not conforming to this description is socially sub-optimal. Indeed, if a producer can influence the price at which its commodity is sold, it will most likely reduce its production in order to increase the final price (and profit) at the expense of consumers. This ultimately reduces the harmony of interest that existed in society. In this scenario, competition is not socially beneficial anymore, as it results in situations where monopolistic outcomes are to be expected. Since actual market conditions usually create competition among a few producers with highly differentiated goods, the implications of this theory for the regulation of competition are far-reaching.

A major problem with the view of competition depicted above is that it is difficult to use it in the context of policy. Indeed, casual observation is enough to realise the point made above that markets often have a small number of producers producing different goods. This difficulty is recognised in the Commerce Act, which states that:

> In this Act "competition" means workable or effective competition. (s 3)

This is an attempt to distance the law and its practice from the benchmark it is using to assess a real situation. In other words, the legislature knows that applying the theory of perfect competition to real markets would be impossible, but it implicitly uses it as a benchmark to assess situations where a "lessening of competition" may occur or where "market power" is being exercised. According to the Act:

> … references to the "lessening of competition" include references to the hindering or preventing of competition. (s 3)

Because the Act does not make it clear when a hindering or a preventing of competition can occur, it is implicitly understood that competition is reduced whenever a situation significantly deviates from the ideal situation (which is where no producer can influence the price and reduce quantity at the expense of consumers and thereby increase his profit). In practice, competition law is about deterring the potential for monopolistic competition as depicted by the theory.

The reader may be led to believe that competition law as it is practised in New Zealand is a good compromise: while the theory cannot be strictly applied, it can serve as a guide to redress situations where competition has been lessened. The problem with this approach is that the theory behind competition law is of questionable validity. A theory is meant to illuminate the causal connections between a series of actual events. However, the theory of perfect competition does not provide an explanation of actual "competition". As George B Richardson explained, it is quite the opposite:

> It is most important to remember that the conditions of the real world are not those of perfect competition and that, if they were, it might no longer be possible for this order to be produced.
>
> (George B Richardson *Information and Investment* 2nd ed, OUP, (1960) p 12)

Indeed, perfect competition presupposes that the facts and the information necessary for the order to take place exist independently of competition itself. (See F A Hayek "Competition as a Discovery Procedure." In *New Studies in Philosophy, Politics, Economics, and the History of Ideas* (1978) London: Routledge.) Standard competition theory describes a world that cannot exist in reality, because it would not possess the information necessary for the order to take place. Unfortunately, this view of competition has inspired policy makers around the world in their endeavors to regulate competition.

THE TRUE MEANING OF COMPETITION

Another approach to competition looks at the market as an entrepreneurially-driven discovery process. (see eg, Israel M Kirzner (1973) *Competition and Entrepreneurship*, (1973) University of Chicago Press; Israel M Kirzner and Frederic Sautet *The Nature and Role of Entrepreneurship: Implications for Policy*, (2006) Mercatus Policy Series, Policy Primer No 4, GMU: Mercatus Center) Indeed, entrepreneurship is the function at the heart of the competitive process. Entrepreneurial activity consists of the discovery and generation of new knowledge enabling hitherto unknown gains from trade to be captured. Entrepreneurial discovery is the process by which competition occurs and is sustained in the market place. It is precisely because of the "imperfection" of the market — such that prices do not convey all existing knowledge — that the system is able to discover and communicate information concerning its "imperfections". Prices are not parameters and individuals do not react to prices as robots would. Prices are communicators of knowledge. However, since all the available knowledge is never entirely communicated via the prices system, this leaves opportunities for entrepreneurs. Indeed, every as-yet-unexploited opportunity for improving the pattern of production expresses itself in the form of an opportunity for profit waiting for entrepreneurial discovery.

An example can help clarify the entrepreneurial process described above. Suppose an entrepreneur discovers that he can buy apples in market A for $3 per kg and resell them for $4 per kg in market B, which is located in a different region. By doing so, he can make a profit of 50 cents per kg (once transportation and capital costs are accounted for). No one had discovered the existence of this arbitrage opportunity before the entrepreneur did. Thus it can be said that he has discovered a knowledge gap in the market. Indeed, before then, market participants who sold apples for $3 per kg in market A did not know that consumers in market B would be willing to pay $4 per kg. Similarly, those who now buy in market B do not know that someone is willing to offer apples for $3 per kg in market A. As these discrepancies in knowledge express themselves in the form of profit opportunities, they will tend to disappear over time. Indeed, the lucrative market for apples will attract other entrepreneurs who will continue closing the gap until the difference in price between the two markets amounts to transportation and capital costs. Other entrepreneurs may come to realise that a profit can be made by buying low in market A and selling high in market B. These other entrepreneurs may follow in the steps of the first one and compete with him by selling apples at $3.90 per kg, thereby reducing the profit made in the arbitrage. Unless the initial entrepreneur finds ways to reduce his production costs to attempt to maintain his profit level, the process will continue until all profit has been squeezed out.

Actual entrepreneurs always attempt to maintain their profits over time via different methods. Branding for instance is one of the most common ways to attempt profit retention. A brand has value because it communicates information to the customers and a strong brand is one that customers will recognise and patronise over alternatives. In the example above, the initial entrepreneur can develop a brand of grocery stores that becomes known for its excellent apples — and this could conceivably be done even in the case where the same apples are cheaper elsewhere. The store could also offer other services that customers like and which help keep the high margins on the apples. The important point here is that profit is uncertain and maintaining any level of profit requires constant attention and entrepreneurial ingenuity. (The term "profit" here refers to "entrepreneurial profit" not "accounting profit". Accounting profit may or may not include entrepreneurial profit. Only entrepreneurial profit results from existing gaps in knowledge that the entrepreneur has discovered. The reason why accounting profit may not include entrepreneurial profit is because accounting profit may be entirely made of the income that accrues to factors of production that the firm owns (ie its net assets). This type of income is just a return on factors, not an entrepreneurial profit; it accrues because of sheer ownership of factors.) The concept of "entrepreneurial profit" should also be distinguished from that of "monopoly rent". The former is necessary to the market process, while the latter only exists under the condition where entrepreneurs are barred (by law) from entering the market. Competition law does not distinguish in theory or in practice between the two concepts, when it is crucially important to do so.

It is in the grasping and exploitation of the discovered profit opportunities that the market performs its function of communication. It is precisely because entrepreneurs can set prices (ie choose the prices at which they sell their goods) that competition is being effected and that new knowledge is transmitted to other market participants. Moreover, entrepreneurs strive to differentiate their products. This process of differentiation is crucial to market competition and must be accounted for. This has important implications for policy, especially regarding market definition.

The main issue with using perfect competition as an ideal reference — even if the practice takes into account the limitations of the real world — is that a static view of competition is what ultimately inspires the regulator. Actual competition (ie rivalry) is truly dynamic. Competition is made of a constant flux of changes — and at any given moment, many of those changes are not yet expressed in market data. As long as entry in the market is open, there is always the possibility that anyone's position can be challenged by a new entrepreneur. The number of players in an industry is irrelevant, as long as entry is available.

Moreover, market prices are always competitive because established entrepreneurs always try to maximise their net revenue over multiple periods taking into account the possibility of new entrants. In other words, established entrepreneurs are always aware of the potential for competition. Some industries necessitate higher initial investment and this is often seen as a "barrier to entry." However, this is only due to the fact that all investments are to various degrees lumpy. In some cases, the initial sunk costs are important, but this doesn't preclude the development of alternatives over time.

This point is important and requires further elaboration. First, at any moment in time, known alternatives are costly. In some cases, the capital costs necessary to start the production of some competing products are low (as seen by the potential entrants) and plenty of competitors mushroom constantly. In other cases, the capital costs are high and thus known alternatives to the existing products are scarcer. Life may seem more comfortable for established entrepreneurs in this latter case than in the former scenario, but this is not necessarily true, as even though known alternatives are costly, another possibility is always present. This is our second point: another threat lies in the innovative capabilities of competitors who can, over time, develop alternative products which require lower initial investments. These alternatives are unknown to current market participants. Entrenched competitors may think that under the current technology of production their situation is secure, but new competitors with new technology can, over time, erode this situation by providing a similar service cheaper. Ultimately, unknown alternatives are the most dangerous ones for incumbents.

Further elaboration of this subject would require dwelling on the theory of monopoly pricing, which would be too long for this paper. In a nutshell, a truly dynamic view of competition shows that there is never any situation of monopoly pricing in a market where entry into any market is open. In the free market system, prices are always competitive. The only source of monopoly pricing thus comes from government privileges. Edward Coke, as well as William Blackstone, established in the early 17th century that it was improper for the King to give trade privileges as this was monopoly. As he explained:

> a monopoly is an institution, or allowance by the King by his grant, commission, or otherwise to any person or persons, bodies politic, or coporate, of or for the sole buying, selling, making, working, or using of anything, whereby any person … are sought to be restrained of any freedom, or liberty that they had before, or hindered in their law-full trade.

> (See Coke (1817) *Third Part of the Institutes of the Laws of England concerning High Treason, and Other Pleas of the Crown and Criminal Causes*, (1817) London: W. Clarke and Sons. For a modern treatment of the issue of monopoly pricing, see Dominick T. Armentano *Antitrust and Monopoly*, 2nd ed, (1990) New York: Holmes and Meier.)

Competition law sees market structure as the determinant of competition. The dynamic approach sees entry as the determinant of competition. The former is very difficult to assess and is to a large extent arbitrary (ie what is lessening of competition in one jurisdiction may not be in another), whereas the latter can be objectively established.

It should now be clear that competition is not a static state of affairs that depends on the number of players in the market. Rather, competition is a rivalrous process of discovery in which each actor (whether a firm or an individual) is continuously striving to do better than its rivals. Rivalry was the notion that 19th century economists had in mind when they talked of competition, not a static state of affairs. Competition does not depend on the condition of plurality of suppliers and consumers who are all price takers. Competition instead is a political concept; it refers to the freedom to enter markets — competition is ultimately about the openness of markets to new entrants. From this perspective, the advantages of competition do not depend on the condition that it is perfect. As mentioned above, it is precisely because of market "imperfections" that the entrepreneurial process exists and that markets generate the information necessary to create the social order that can be observed. In this sense, competition law is not necessary for the efficient functioning of markets because the process of entrepreneurial discovery is constantly at work making sure any situation where true economic profit can be made does not last. Moreover, since it is because of the existence of these situations that the market process is set in motion, no laws should interfere with their existence. The danger is that competition law may affect the self-correcting properties of the market system—an outcome worse than the danger of monopoly pricing.

THE REALITY OF COMPETITION LAW

The reality of competition law is not made of a strict application of perfect competition but rather of a notion of "workable competition". Perfect competition is only a reference, and it is well-understood that reality is made of cases that only approximate that ideal. However, the practice of competition law suffers from many drawbacks, which are a direct consequence of the underlying theory of competition that the law uses. For example, competition law often operates under the assumption that value can objectively be assessed. Economics teaches that valuation is a phenomenon of the mind and is therefore subjective. This means that no one knows how much someone values a given good. It is only through exchange that some of that valuation be revealed. Costs also are subjective. (see, eg, James Buchanan *Cost and Choice*, (1969) U of Chicago Press) Some well-known concepts of competition law are assessed in this section.

Market definition

An important example of the difficulty in applying a static benchmark to actual situations is that of market definition. The practice of competition law requires the isolation of markets from each other — this is the "market definition". However, in the reality of competition, markets are not isolated but are in a permanent symbiosis. Take the example of someone who desires being warm in her house in the winter. She has many alternatives available to her: woollen blankets, more electricity consumption by appliances such as electric blankets and radiators, insulation systems, woollen jerseys, polar fleeces, etc. All these goods and more are in competition for her dollar. Moreover, not only the final goods are in competition but also all the inputs that enter the production of these goods. It follows that markets are not isolated because of (a) the subjective character of what constitutes a substitute (eg some people see woollen jerseys as a substitute for extra heating while others don't) and (b) the interdependency existing among goods in the complexity of market relationships. At the end of the day, all goods compete against all other goods for the consumer dollar.

Market definition ultimately rests on the arbitrary decision of the Commission, as there is no objective definition of a market. For instance, whether electric blankets should be included in the woollen blankets market is left to the Commission to decide. Because this decision cannot ultimately be scientifically established, there is always a level at which a sufficiently narrow market will create a concern from a competition law perspective. Moreover, the narrowness of the definition will depend on how the dynamic elements of entrepreneurial discovery are taken into account. It may be in the interest of competition authorities to define markets in a way that raises competition issues.

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Lessening of competition

Lessening of competition is a key notion of competition law. It is the object of Part II of the Act (Restrictive Trade Practices). While lessening of competition is crucial to the application of competition law, it is never clearly defined in the Act. The Act stipulates that contracts, arrangements, and covenants that may lead to a lessening of competition are prohibited. This generally refers to exclusionary trade practices. More specifically, s 29 explains that provisions that purposefully prevent, restrict, or limit the supply of goods or services are prohibited. The notion of "purpose" is important here. Similarly, s 30 explains that provisions that purposefully aim at fixing, controlling, or maintaining the price for goods or services are likely to substantially lessen competition.

While it would take more than just a paragraph to provide a complete analysis of the notion of lessening of competition, a few remarks are in order. First, the description of the notion shows that it relates to monopoly pricing whereby some producers are in a situation of potentially restricting supply in order to derive (monopoly) profits. This is based on a static understanding of competition and thus is oblivious to the dynamic aspect of the market process. Second, the Act sees setting prices and quantities through contracts as, in some cases, undesirable. As said above, entrepreneurs decide upon prices and quantities all the time. They intentionally set these variables so as to maximise their expected net revenue in the foreseeable future. As the economics of contracts explains, this may mean that in some cases bundling (where many goods or services are sold together), foreclosure (where various parties enter into long-term arrangements), or pricing below costs is necessary for the entrepreneurs to plan production. It is only if one adopts a static benchmark that these trade practices are problematic. In a dynamic environment, setting prices and quantities are the way entrepreneurs seize profit opportunities (and in the process tend to correct market imbalances). Moreover, as long as there is open entry into the market, there cannot be a lessening of competition.

Market power

Related to the lessening of competition is the notion of market power. Even though it is often used in competition law, this notion is not clearly defined in the Commerce Act. Section 36 of the Act details the implications of a substantial degree of power in a market. However, it does not explain what that market power consists of. In practice, market power is understood as the ability for a producer to be a price maker (ie to increase its prices without losing customers).

Section 36 of the Act explains that if a person has market power, it should not take advantage of this power to restrict entry in the market, prevent anyone from engaging in competitive conduct, or eliminate a person from that or any other market. From the perspective of dynamic competition, this section makes little sense. It is worth repeating here the point made above: every producer will always tend to maximise its net revenue over many periods. It follows that a producer will set the price as high as possible without enticing others to come and compete. At times, the imminent threat of entry forces the incumbent to reduce its price. This may deter entry, or it may not. The process of discovery entails that prices can change and that entrepreneurs decide on the prices at which they want to sell their production.

Entrepreneurs are price makers and from this perspective have "market power". However, entrepreneurial activity ultimately succeeds by offering cheaper and better quality products than what's available in the market at a given time. This process of discovery pushes prices down over time. The best guarantee that can be offered is to have the market open to anyone who wants to challenge the incumbents. In this sense, everyone has market power. Market power is another concept inherited from the notion of perfect competition, which has no place in a dynamic understanding of the market.

Dynamic efficiency

The issue of "dynamic efficiency" shows how difficult it is for competition authorities to deal with a non-static view of competition. The general notion of "efficiency" is referred to in s 3A of the Act, but there is not special reference to dynamic efficiency. It is left to the Commission to decide whether a given case requires application of dynamic efficiency.

Dynamic efficiency consists in considering future potential threats and changes to the market when assessing a situation. However, because taking into account every potential future change is, needless to say, impossible and also contrary to a static benchmark of competition, the concept is rarely used well (that is, accepting the consequence that the market is always competitive as long as entry is open). Any market open to new entrants is in a constant state of change and is thus dynamic. Competition authorities often limit their use of dynamic efficiency to certain cases when it should be widely used. However, a wider use would tend to negate the use of competition law.

WHERE IS THE CRIME?

It has been argued above that competition law sees problems with market structures when, in fact, there are none. The level of competition does not depend on the structure of the market but on the possibility of entry. It follows that competition is a political and institutional problem. Competition depends on the quality of the institutions that exist in a jurisdiction. This includes the type and quality of regulations that are in place.

One may wonder why competition law exists in the first place if what matters at the end of the day is the quality of the institutional and regulatory framework. One response to this can be found in the economics of legislation (what is also known as "public choice economics"). Firms in the market always have two ways to compete:

(a) they can do better than their competitors by providing higher quality and cheaper products, or

(b) they can seek to change the rules of the market in their favor.

Some economic historians have traced the origins of competition law as the result of the latter. Small firms that could not compete against the emergence of trusts (because trusts were more efficient than older forms of corporate structure) decided to appeal to the US Congress to have the law changed in order to protect the "weak" against the "strong". (See eg Werner Troesken "The Letters of John Sherman and the Origins of Antitrust" (2002) 15 *Review of Austrian Economics* 275-95)

While the common law has had competition provisions for a long time, it is only with the statutes on anti-trust and the Sherman Act at the end of the 19th century that competition law took on its modern outlook. Competition law finds its root not so much in the defence of the consumers, but rather in the use of the law to benefit a well organised group of small producers. Today competition law has been accepted as a necessary regulation of markets, but this does not justify its raison d'être. Many groups derive special favors from the law and benefit from it at various times, regulators, lawyers, economists and so on. Even defenders of competition law such as William Baumol and Janusz Ordover have expressed their concerns over the misuse of the law:

> There is a specter that haunts our antitrust institutions. Its threat is that, far from serving as the bulwark of competition, these institutions will become the most powerful instrument in the hands of those who wish to subvert it
>
> (Baumol and Ordover "The Use of Antitrust to Subvert Competition". (1985) 28 J of Law and Econ 247-65)

A worrying issue with competition law lies not so much in its public choice origins, but rather in the absence of a crime. Indeed, competition law is an indictment of a market reality but without any actual culprit. How can market actors who respect property rights and contractual engagements be criminals? Competition law makes persons who are innocent of any crime culprits simply because they happen to be involved in a market structure which does not correspond to the canons of perfect competition. It is important for legislators to keep in mind that the market process takes time and that entrepreneurs are always price makers. However this reality of competition is hardly compatible with the political process. When a situation is deemed as "monopolistic" by the public, explaining that entrepreneurs will take care of it over time is often irrelevant because something must be done now. Conversely, there may be examples where the political imperative is towards monopoly, especially in agriculture and the dairy industry. The political nature of competition law in New Zealand can be seen from s 26 of the Commerce Act. The Commerce Commission is supposed to have regard to the economic policies of government, which in some cases can override concerns that the Commission may have regarding a certain situation. At the end of the day, competition law interferes with the market process. This is the crime at the crime scene.

Competition law finds its root not so much in the defence of the consumers, but rather in the use of the law to benefit a well organised group of small producers

CONCLUSION

Competition law was established on an unrealistic understanding of competition. In spite of what the law in New Zealand aims to achieve (namely a framework for workable competition), the practice of competition law relies on the view of competition as a static state of affairs. However, actual competition is a rivalrous entrepreneurial process by which the knowledge enabling a better coordination of individual plans is discovered over time.

While the aim of ensuring that the harmony between consumers and producers is desirable, it is not by focusing on market structures that one may achieve that goal. Rather, it must be understood that the competitive process takes place within a set of institutions that guarantee the functioning of entrepreneurial discovery and the exploitation of business opportunities over time. These institutions and regulation must guarantee entry into any market to anyone desiring to compete.

Competition law finds its origin in the desire to change the rules in order to protect some groups against others. Under the disguise of consumer protection, competition law has in fact protected some producers from the greater efficiency of their potential competitors. Indeed, competition can be difficult for some incumbents who run the risk of being outcompeted. However, this process is necessary if the ultimate goal is to let consumers (indirectly) dictate the allocation of resources according to their preferences. The danger with competition law is that it interferes with the entrepreneurial process — a cure worse than the disease. ❐