What's Wrong with New Zealand's Public Benefit Test?

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New Zealand courts and regulatory authorities have since 1994 adopted an extreme neoliberal version of the public benefit test, treating wealth transfers from consumers to monopolists as welfare-neutral. This abandonment of the long-established consumer-welfare or balancing-weights standards used in most other OECD jurisdictions rests upon a misconstruction of the alleged inability of economists to reach consensus on how to evaluate changes in income distribution. The intellectual cul-de-sac occupied by "new welfare economics" should leave policymakers free to attack monopoly profits without having to endure utilitarian criticisms from neoliberal economists. In doing so, New Zealand policymakers would be acting in accordance with strong economic arguments for restraining monopoly, drawn from the wider mainstream of the economic literature and requiring no utilitarian underpinning.

> "[A] net public benefit analysis considers net total welfare effects. Under this analysis, any deadweight efficiency loss due to allocatively inefficient prices would count as a net public detriment, but any transfer of wealth from consumers to suppliers (or vice versa) would not... [E]xcess returns being reduced, with a transfer of wealth from suppliers to consumers ... [would constitute] a net benefit to acquirers. [However] [t]he increase in consumers' wealth is matched by a reduction in suppliers' wealth (resulting in zero net public benefit)."

NZ Commerce Commission 2003, pp.14-15.

> "For the purpose of determining both detriments and benefits, the longstanding practice has been to ignore wealth transfers from New Zealand consumers to producers that result from higher prices. The underlying principle is that the welfare effect of changes in the distribution of income, where one group within the public of New Zealand gains while another group simultaneously loses, is neutral...We are satisfied that the introduction of s 1A should not disturb the Commission's established practice of treating as neutral any wealth transfers between New Zealand consumers and producers."
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> High Court 2004, paragraphs 238 and 241., paragraphs 238 and 241.

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1. Introduction

Monopoly profit is a transfer of wealth from consumers to the monopolist. Consumers are worse off, and the monopolist is better off, by the amount of the transfer. What benefit (if any) does society experience, if a regulator eliminates these supernormal profits by forcing price down to the competitive level? This issue is crucial for the cost-benefit evaluation of mergers, restrictive trade practices, and regulation of monopoly.

This paper argues that there are strong economic arguments for treating monopoly rent as a social detriment, that any "public benefit test" should so treat them, and that the argument most commonly advanced in New Zealand for the "total surplus standard" – that welfare economics provides no secure reason in principle for comparing the gains of monopolists with the losses of consumers – provides no good reason for policymakers to ignore transfers, and altogether misses the really important economic arguments for regulating monopoly rents out of existence.

2. Background

Almost alone among OECD countries, New Zealand has, since the mid 1990s, adopted what economists often call the "total surplus standard" when evaluating the economic impacts of mergers and takeovers, restrictive trade practices, and price control. The proposition underlying this standard is that when wealth is transferred from one person to another within the community, there is no net welfare effect on society as a whole, so that monopoly profits are not a net detriment to society and can be set aside when adding up social costs and benefits under the so-called "public benefits test".

The focus of the test is loosely spelt out in the Commerce Act 1986, sections 61(8) and 67(3)(b),which relate respectively to authorisation of restrictive trade practices and of mergers or takeovers which do not meet safe-harbour requirements of market structure. In both those cases, the Commerce Commission is required to decide whether the practice or takeover "will result, or will be likely to result, in such a benefit to the public that it should be permitted". The same test has recently been extended to the consideration of price regulation under Part IV of the Act.[1] The Act is silent on what should be included in the public benefit test, leaving the courts and the Commission free to impose their own interpretations.

The USA and the EU (including the UK) give primacy to the welfare of consumers, and therefore count the elimination of monopoly-rent transfers as a

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[1] See Dalziel (2002) for an early indication that s.53 of the Act, providing for ministerial imposition of price control, was being interpreted as implying a public benefit test; and the passage quoted at the beginning of this paper from the Commerce Commission's 2003 Gas Inquiry Framework Paper.

public benefit.[2] This approach is commonly called the "consumer welfare standard". Australia and Canada have flirted with the total surplus standard, and the ACCC in Australia has moved towards the New Zealand position on wealth transfers in recent years[3]. In Canada, however, the Federal Court of Appeal held in 2001[4] that the Competition Act 1986 did not allow use of the total surplus standard in an efficiencies defence of a merger, and that the so-called "balancing weights standard" must be used instead.[5]

Under the present interpretation of New Zealand law by the Commerce Commission and the High Court, monopoly rents are considered welfare-neutral unless and until either Parliament, or the Government of the day, makes an explicit political decision to the contrary. This means that New Zealand has departed from the long-standing English common law tradition that only fair and reasonable charges may be imposed for access to essential facilities, and that ordinary citizens could have recourse to the courts when confronted by a price-gouging monopolist. The New Zealand Court of Appeal, in *Vector v.Transpower*[6], made it clear that the common law "doctrine of prime necessity" had been superseded by the Commerce Act, and the courts therefore had no role to play in the control of monopoly. That task lay entirely with the Minister of Commerce.

It was not always thus. Until the early 1990s it was generally assumed (within Government as well as outside it) that the Commerce Act in some way gave protection to consumers against having to pay monopoly prices. The Privy Council in its *Telecom v Clear* decision in 1994 stated clearly that the control of monopoly profits lay not with section 36 but with Part IV of the Act, which provided for the Minister of Commerce to trigger regulatory proceedings against offending firms. In

2 The adoption of the consumer welfare standard for purposes of monopoly regulation in the USA dates from the 1944 Supreme Court decision in *Federal Power Commission v Hope Natural Gas Company*, 320 U.S. 591 (1944). In Europe the Treaty of Rome, Article 86(a), prohibits a firm in a dominant market position from "directly or indirectly imposing unfair purchase or selling prices or unfair trading conditions", a provision which the courts have interpreted as embodying the consumer welfare standard. (See European Commission 1977 p.9.)

3 For example, in relation to electricity network investments the ACCC has recently dropped its previous "customer benefit test"; see ACCC (2002) p.2, and (2004) section 2.5 pp.19-22, where the ACCC explains its decision to treat wealth transfers as neutral from the public-benefit point of view.

4 *Canada (Commissioner of Competition) v. Superior Propane Inc. (C.A.)*, [2001] 3 F.C. 185.

5 Under the balancing-weights standard an explicit weight is attached to each of the various parties affected by wealth transfers and the net balance is calculated using these weights. A weight of one for consumers and zero for the owners of the merged firm would correspond to the consumer welfare standard, whereas equal weights for both would yield the total surplus standard.

6 *Vector Ltd v Transpower New Zealand Ltd* [1999] 6 NZBLC 99-482.

reaching that position, the Privy Council took it for granted that the consumer welfare standard would be applied to regulatory decisions[7]:

> "It is important to note that s.36 is only one of the remedies provided by the Commerce Act for the purpose of combating over-pricing due to monopolistic behaviour ... S.36 is only part of an overall statutory machinery for dealing with trade practices which operate to the detriment of consumers. Another part of such machinery (Part IV) is specifically directed to the regulation of prices in markets which are not fully competitive....
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> "... s. 36 is designed to produce the competition which will, it is hoped, in due course compete out monopoly rents; Part IV of the Act enables immediate price restriction to be imposed by regulation. Since the Commerce Act contains the machinery for dealing with the monopoly rents in both ways, it would, in their Lordships' view, be wrong to construe s.36 so as to extend its scope to produce a quasi-regulatory system which the Act expressly provides for, with all the necessary powers and safeguards, in another part of the Act....
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> "[T]he elimination of ... monopoly rents is (otherwise than by competition) within the province of Part IV of the Act."

Within the New Zealand Government, Treasury and Commerce were, by the 1990s, leading proponents of the total surplus standard; the Department of Justice was vehemently opposed and argued for retaining the traditional consumer welfare standard under which monopoly rents were regarded as detrimental.[8] Cabinet adopted in February 1993 a proposed amendment to section 3A of the Commerce Act, to provide that the words "benefit to the public" would be replaced by "benefit to New Zealand", that the consideration of allocative, productive and dynamic efficiency was to be "the principal element of the analysis", and that "no account shall be taken of the identity of those who gain the "benefit to New Zealand". This promised amendment to the statutory wording was never implemented, but the Commerce Commission acted as though the change had been legislated, and adopted in its 1994 *Guidelines to the Analysis of Public Benefits and Detriments* the view that transfers were welfare-neutral, as part of an extreme version of the so-called "efficiencies defence for mergers" derived from Williamson (1968) and Bork (1978).

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7 *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385, pp.404 and 408.

8 See the 1992 *Review of the Commerce Act 1986* by officials from Treasury, Commerce, DP and C, and Justice.

3. Public Benefit, Total Surplus and Consumer Welfare

The distinction between the two standards for welfare analysis is straightforward. The "consumer welfare standard" counts both the deadweight loss triangle and any wealth transfer from consumers as detriments attributable to monopoly. The "total surplus standard" treats monopoly rents as a simple transfer with no national welfare implications, focusing only on the deadweight loss triangle. A balanced-weights approach assigns weights to the various parties affected by the transfers. (A weight of 1 for consumers and zero for producers, yields the consumer welfare standard; equal weights for all yields the pure total surplus standard.)

If society were really indifferent between a world with no monopoly rent transfers and one with such transfers, it would follow that transfers have zero net impact on society's well-being. But there is nothing in economic theory pointing to any conclusion that society does not care about transfers, and there is therefore no principled basis on which economists could advise New Zealand regulatory agencies to ignore transfers.

Simple observation confirms that some transfers enjoy social approval (charitable donations, welfare benefits) and some encounter disapproval (bank robbery, fraud). Commonsense and revealed preference say that society considers itself improved by the former, and damaged by the latter. On what basis could it ever be possible to suppose that monopoly rents happen to lie just exactly on the midpoint between these two ends of society's normative spectrum?

The Commerce Commission's argument quoted earlier that "a transfer of wealth from suppliers to consumers would constitute a net benefit to acquirers, [but] the increase in consumers' wealth is matched by a reduction in suppliers' wealth (resulting in zero net public benefit)" is thus, on the face of it, extremely improbable. Applied to monopoly profits, it is dubious even as a starting point for a hypothetical argument about national welfare, let alone as the premise on which the towering edifice of the total surplus standard and the public benefit test have been built.

Like many great mistakes, this one began its life modestly enough, from two developments in mid-twentieth century economics. Robbins (1932) and Hicks (1939 Chapter 1) rejected the idea that economics had the tools to compare the utility of one individual with that of another, and on this basis removed neoclassical welfare economists from having any specialised disciplinary ability to say anything at all about transfers. Politicians might set up the welfare state, but economists (at least, neoclassical ones) had nothing relevant to say about it apart from peripheral comments on the relative efficiency of different tax regimes used to fund transfers from rich to poor. (Cf Little 1950, Van der Graaf 1957).

The view that economists could offer no means of evaluating the individualistic welfare impact of transfers does not entail the claim, often encountered in New Zealand policy discourse, that economists are somehow in a secure position to declare transfers to be value-neutral, despite their self-declared lack of any theoretical utilitarian basis for making any claims at all about transfers. The position adopted by the Commerce Commission in authorisation cases between 1994 and 2004, subtracting suppliers' losses from consumers' gains to reach a clearly-defined numerical value of zero, cannot be based upon, or defended by reference to, the mid-twentieth-century revolution in welfare economics or the theoretical paradigm which it produced.

It was out of the wreckage of the old utilitarian welfare economics that the phoenix of social cost-benefit analysis arose in the 1960s, epitomised by the manual produced for the OECD by Little and Mirrlees (1974), and urged on by Arnold Harberger (1971) who considered that theoretical nitpicking ought not to be allowed to hold up the progress of empirical work.

Little and Mirrlees (1974 p.22) address directly the question of the welfare implications of transfers:

> Surely a dollar's worth of consumption by a rich man and a poor man cannot both be reckoned as a benefit of $1 to society? ... We are now hard up against one of the basic theoretical and practical problems of economics. .... Here we shall merely record that the profitability measure treats a dollar's worth of consumption as equally beneficial no matter who gets it. Consequently profitability will be a good measure of the net social benefit (i.e. the social profit) of a project only if, in the case under consideration, neglect of income distribution can be justified.

The remainder of the 380-page book is devoted to the adjustments that must be made to observed price and quantity magnitudes before the analyst can treat any dollar as equivalent to any other.

The phrase "a dollar is a dollar" is frequently encountered amongst economists working in New Zealand hearings. If it has no theoretical warrant, where does its supposed authority come from?

4. Harberger and "a dollar is a dollar"

Harberger, in his seminal work on measuring distortions of resource allocation, noted (1954 p.87) that "I have discussed only the welfare effects of resource misallocations due to monopoly. I have not analysed the redistributions of income that arise when monopoly is present. I originally planned to discuss this redistribution aspect as well, but finally decided against it." He gave no reasons for this decision, but relegated the issue of redistribution to "my more metaphysically inclined colleagues".

When he finally turned to the issue of the effect of wealth redistributions, Harberger (1971) was concerned not with theory but with practical issues of implementing cost-benefit analysis. The paper was "an open letter to the profession" pleading for the adoption of three ad-hoc assumptions to be used in applied welfare economics. The third of these was that (p.785) "when evaluating the net benefits or costs of a given action (project, program, or policy), the costs and benefits accruing to each member of the relevant group (e.g. a nation) should normally be added without regard to the individual(s) to whom they accrue".

Harberger's aim was pragmatic: to encourage economic analysts to press ahead with the task of estimating empirically the consequences of various alternatives, setting aside difficult and complex issues such as distribution which might otherwise bog the analysis down.

Harberger's most fundamental line of argument for assuming that income redistribution could appropriately be set aside was that economists have nothing to say on distributional matters that cannot be said equally well by laypersons (1971 p.785):

> "... any program or project that is subjected to applied-welfare-economic analysis is likely to have characteristics upon which the economist as such is not professionally qualified to pronounce, and about which one economist is not professionally qualified to check the opinion of another. These elements – which surely include the income-distributional and national-defense aspects of any project or program, and probably its natural-beauty aspect as well – may be exceedingly important, perhaps even the dominant factors governing any policy decision, but they are not a part of that package of expertise that distinguishes the professional economist from the rest of humanity. And that is why we cannot expect to reach a professional consensus concerning them. If we are to take a (hopefully justified) professional pride in our work, we must also have the modesty and honesty not to claim for our profession more than we are particularly qualified to deliver."

Harberger thus argued that redistributive effects might well dominate the final policy decision, but that economists had nothing to contribute professionally to that aspect of the decision. He certainly nowhere suggested that economists should press upon policymakers a professional view that distributive effects are unimportant, or that policymakers ought to ignore distributive matters simply because economists had no means of reaching a professional consensus. Harberger's argument was for economists to stand back and allow others to reach informed judgments on matters of redistribution.

A second purely-pragmatic argument was (Harberger 1971 p.787) that "giving equal weight to all dollars of income is mathematically the simplest rule." In making this purely practical suggestion, Harberger was neither asserting that in principle all dollars are equal, nor arguing for decision makers to proceed on the basis of that assumption. His position was that the economist's evaluation should stop when it reached the boundaries of the disciplinary consensus, and that from that point on, the decision-making process must confront the distributional issue without help from economists.

5. So Why Should We Care About Rent Transfers?

Although the new welfare economics discourse in which Harberger (1971) was engaged is self-consciously unable to say anything about income distribution, the main reasons traditionally advanced by economists for the control of monopoly rents remain entirely intact. In this section a brief review will be undertaken of the economic literature on rent seeking, growth incentives, and contractarian propositions on the rights of private property.

5.1 Rent Seeking

Tullock (1967) pointed out that a rational monopolist, when confronted either by a potential new competitor or by a regulator seeking to eliminate monopoly rents, would be willing to spend up to the full amount of its monopoly rents on unproductive lobbying, manouevres and litigation to protect its market power. Consequently, scarce resources up to the value of the monopoly rent are apt to be diverted from productive uses into unproductive rent-seeking activity, funded out of rent transfers. Since Tullock's seminal paper, a series of researchers including Posner (1974), Buchanan et al (1980), Krueger (1974), Tullock (1989) and Rogerson (1982) have found both logical reasons and empirical evidence for both economic growth and factor productivity to be negatively correlated with the extent of monopolistic rent-seeking and rent-taking – what Hall and Jones (1999) have called "diversionary activity".

5.2 Monopoly Rents, Institutions, and Economic Growth Incentives

Adam Smith declared the minimum institutional requirement for improvements in the wealth of nations to be "a tolerable administration of justice", under which heading he included both the secure possession of private property and the protection of the general public from predation by cartels or monopolies. Since his time, economic theory has continued to develop the theme that certain institutional requirements are fundamental to the successful functioning of a market economy. A primary institutional requirement is that those who create wealth should appropriate, as their reward, the full fruits of their efforts, free from expropriation by either excessive taxes or monopolistic taking of rent.

The taking of monopoly profits on essential facilities has been outlawed for centuries under the common law of England and the USA because it predates on the rights of ordinary competitive small businesses to appropriate the legitimate fruits of their efforts: a competitive return on their investments, and a fair reward for their labour and entrepreneurship. Freedom from expropriation seems, on the record, to be observably good for economic growth, and vice versa.

At the most general historical level North (1990) has emphasised the centrality in western economic development of established institutions to protect property rights and sanctity of contract, including institutions which protect the dispersed price-taking operators of competitive business against the abuse of market power by monopolists. Other recent work by economists focusing on the wide disparities in income and output per head across the countries of the modern world has found strong empirical links between high productivity and rapid economic growth on the one hand, and institutions that limit the exercise of monopoly power on the other.

Hall and Jones (1999 p.84) argue that

> "differences in capital accumulation, productivity, and therefore output per worker are fundamentally related to differences in social infrastructure across countries. By social infrastructure we mean the institutions and government policies that determine the economic environment within which individuals accumulate skills, and firms accumulate capital and produce output. A social infrastructure favourable to high levels of output per worker provides an environment that supports productive activities and encourages capital accumulation. Such a social infrastructure gets the prices right so that, in the language of North and Thomas (1973), individuals capture the social returns to their actions as private returns.
>
> Social institutions to protect the output of individual productive units from diversion are an essential component."

Along similar lines, Parente and Prescott (1999) have developed the Classical economists' view that "monopoly power impedes economic progress". Acemoglu et al (2002 p.1235) have proposed that "a cluster of institutions ensuring secure property rights for a broad cross-section of society ... are essential for investment incentives and successful economic performance. In contrast, *extractive institutions*, which concentrate power in the hands of a few and create a high risk of expropriation for the many, are likely to discourage investment and economic development".

Easterly (2002), Stiglitz (2002), Barro (1999), Olson (2000), Engerman and Sokoloff (1999), and Rodrik et al (2002) are among the many prominent economists who in recent years have concluded that institutional arrangements, and particularly those which relate to freedom from appropriation of monopoly rents and general incentives for investment, are the single most-important determinant of relative growth performance across countries.

5.3 The Contractarian Position

Monopoly rents are secured by hold-up of consumers, not by free arms-length bargaining in an arena where neither party is captive to the other. Other things equal, society does, and arguably should, regard coerced transfers such as those resulting from hold-up of consumers by firms with market power as detrimental, simply because of the procedure by which they are secured. To allow society's income distribution to be determined by the exercise of market power rather than by agreed and democratically-sanctioned processes is corrosive of the fabric of civil society[9].

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[9] This was one of the factors listed by Williamson (1968 and 1977) as possibly justifying regulatory intervention against monopoly.

Issues of political philosophy and procedural justice are inescapable when we ask: by what right does a monopolist appropriate the wealth of others? None of the prevailing theories of property rights suggests that mere ownership of a monopoly firm conveys automatically the right to charge the monopoly price. The reason has been clearly outlined by Nozick (1974) pp.179-180:

> "Each owner's title to his holding includes the historical shadow of the Lockean proviso on appropriation. This ... excludes his using it in a way, in coordination with others or independently of them, so as to violate the proviso by making the situation of others worse than their baseline situation. Once it is known that someone's ownership runs afoul of the Lockean proviso, there are stringent limits on what he may do with (what it is difficult any longer unreservedly to call) 'his property'. Thus a person may not appropriate the only water hole in a desert and charge what he will. Nor may he charge what he will if he possesses one, and unfortunately it happens that all the water holes in the desert dry up, except for his.... Similarly, an owner's property right in the only island in an area does not allow him to order a castaway from a shipwreck off the island as a trespasser, for this would violate the Lockean proviso."

The English common-law doctrine of prime necessity coincides closely with Nozick's argument: it states that no more the fair and reasonable charges may be recovered from members of the public using an essential facility.

6. Conclusion

It has been a standard debating tactic of advocates of the total surplus standard since Bork (1978) to insist that the only possible reason any policymaker or analyst could have for treating rent transfers as a social detriment is some ideological defence of the poor against the rich (or of the "deserving" against the "undeserving"). The weak neoclassical proposition that economists have no reason to consider any group more "deserving" than any other is puffed up to the strong proposition that wealth transfers are welfare-neutral.

The two fallacies in this neoliberal case are readily identifiable. First, if economists have no means of evaluating alternative wealth distributions, as neoliberals assert, then no economic objection can be raised if policymakers determine that monopoly rent transfers are undesirable and should be regulated. Too many neoliberal advocates, in New Zealand as elsewhere, translate theoretical agnosticism about distribution into an ideological defence of market power, excess profits, and the vested interests that benefit from these.

Second, the ability or inability of welfare economists to resolve the problem of comparing individual utilities one with another is neither here nor there in the debate over regulation of monopoly. The general economic case against unregulated monopoly stands on its own with no need of any utilitarian underpinning.

Whether or not economists can weigh up the welfare of different groups, they can emphatically reach theoretically- and empirically-grounded conclusions on the consequences for long-run economic performance of alternative wealth-distribution and monopoly-pricing arrangements. It is not necessary to resort to contentious claims about cardinal utility or the "deservingness" of different groups in order to derive long-familiar propositions about the efficiency properties of competitive (as distinct from monopoly) prices, and the detrimental effects of excess wealth transfers from consumers to producers.

An important part of the economics profession has allowed itself to become caught in the intellectual *cul de sac* of the impossibility of interpersonal welfare comparisons; but the new-welfare-economics impasse is simply bypassed by arguments derived directly from long-run dynamic economic efficiency and from the sort of contractarian constitutional arguments to which economists are easily drawn. The underlying fallacy to which the neoliberal argument falls prey is the assumption that long-run social production is independent of income and wealth distribution and of the procedures by which that distribution is established and altered (the "separability argument").

That society's resolution of "distributional" issues (including most importantly the allocation of property rights and the limitations placed upon the exercise of those rights at the expense of fellow-citizens) has no role in the maximization of wealth is too improbable a notion to provide even a satisfactory provisional premise for a hypothetical argument – let alone a major plank of antitrust policy.

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