Economic, Legal and Political Theory in Relation to the New Zealand Commerce Commission's Public Benefits Test

Geoff Bertram

School of Economics and Finance

Victoria University of Wellington

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ABSTRACT

The New Zealand Commerce Commission has argued that there is no net public detriment attributable to transfers of monopoly profits from consumers to producers, since the sole grounds for regulating natural monopoly prices must be the pursuit of economic efficiency. A possible implication is that a well-run monopoly utility such as a gas pipeline which adopts an allocatively-efficient two-part tariff would be exempt from price control under Part IV of the Commerce Act 1986, unless close attention is paid to very long-run effects of price gouging on the economy-wide level and pattern of investment. This paper argues that the Commission has erred in adopting a "public benefit test" which amounts to a neoliberal hijacking of the regulatory framework set out by Parliament. The line of argument adopted by the Commission rests upon the false premise that monopoly profit-taking by the owners of essential facilities offends against no basic principle other than some "arbitrary" political concern for income equality.

In fact, substantial reasons for regulating the prices of natural-monopoly utilities are to be found in areas of economic and constitutional theory far from the "new welfare economics": particularly in growth theory which focuses (as did Adam Smith) upon the importance of institutions, incentives and property rights for successful long-term economic development; and in theories of the state which simultaneously legitimate and limit the rights of individuals to exercise rights of private property. The old common-law "doctrine of prime necessity", it is argued, is still alive in New Zealand and is embodied in, not eliminated by, the Commerce Act 1986

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1. Introduction

1.1 The Commerce Commission's Current Posture

New Zealand has gone further than most other countries – certainly further than other OECD countries – in its official adoption of the Chicago School view that the taking of monopoly profits is not, *per se*, against the public interest. As the New Zealand authorities see it, monopoly profits are socially undesirable only if they entail some identifiable detriment to a narrow conception of economic efficiency. Apart from efficiency considerations, monopolistic rents are viewed simply as transfers from consumers to producers, with no clear welfare implications, and hence of no interest to policymakers or regulators.

The official position is reiterated in a recent paper from the New Zealand Commerce Commission (2003). The paper lays out the analytical framework for a pending investigation into allegations of monopolistic price-gouging by the owners of New Zealand's natural gas pipeline networks. These networks are generally agreed to be natural monopoly facilities. The Commission explains that under s.56 of New Zealand's Commerce Act 1986, any decision to regulate pipeline prices would have to be justified by reference to "a net public benefit test, as distinct from a net acquirers' benefit test" (Commerce Commission 2003 p.14 paragraph 1):

> In summary, 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.

The Commission notes that "the potential benefits of control [i.e. price regulation] relate to reducing any inefficiencies … and/or excess returns in a market" but it immediately sets to zero the public benefits of reducing the latter (*Ibid*. p.15 paragraph 1.90):

> [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).

In terms of the economic theory of regulation the Commission has, in short, committed itself to use the so-called "total surplus standard" when evaluating proposals not only for mergers and takeovers, but also for regulation of natural monopolies, and has rejected the alternative "consumer welfare standard"[1] as

1 These terms and the concepts behind them have recently been discussed extensively by the Canadian Competition Tribunal and Federal Court in the series of *Propane* decisions discussed later in this paper. For summaries see Townley (1999) pp.13-29 or Camesasca (2000) pp.1-3 and 40-73.

well as the intermediate "price standard"[2]. This extension of the total surplus standard from the merger context to the evaluation of monopoly pricing per se (an extension foreshadowed in Pickford 1993 p.220 footnote 14) brings clearly into focus the issue of wealth transfers from consumers to producers – an issue which has dogged the so-called "efficiency defence", based on the "total-surplus standard" for welfare evaluation, in merger cases around the world[3].

A shift from the consumer-welfare to the total-surplus standard in merger cases by New Zealand's executive, Commerce Commission and High Court occurred during the period 1987 – 1993 (for discussion of the key cases and events see Ahdar 1991 and Pickford 1993; for the underlying issues see Easton 1989 and Pickford 1989). The extension of the merger guidelines to an outright defence of monopoly profit *per se* on the grounds that it is merely a wealth transfer was implicit at that time, but was masked by the focus on mergers rather than monopoly per se in public debate prior to the Commission's 2003 *Framework Paper* for its regulatory inquiry into gas pipelines.[4]

As will be seen in later sections of this paper, the Commission's position coincides with the typical treatment of the problem of monopoly in the latest generation of microeconomics textbooks, and with a strong current of opinion among "neoliberal" economists and lawyers in the antitrust field, associated with the so-called "Chicago School". It represents, however, a dramatic departure from much longer-established common-law practice in western democratic societies; it is incompatible with the main prevailing theories of justice and politics on both the left and the right of the ideological spectrum; and most importantly from an economist's point of view, it runs directly counter to the lessons of recent empirical research results in the economics and economic history of growth and development.

The aim of this paper is to explore those conflicts and to argue for a rehabilitation of the old-fashioned view opposed to the taking of monopoly rents by either natural monopolists or state-franchised monopolies (tax farms).

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2 Fisher et al 1983; for an early proposal that the price standard be adopted in New Zealand see Pickford (1989) section 5.7 pp.111-113.

3 This trend represents the carrying into practice of proposals originating with Williamson (1968) and Bork (1978). Key developments have been New Zealand's 1991 Commerce Act amendments and 1994 Merger Guidelines; Canada's 1985 Competition Act and 1991 Merger Guidelines; the US Federal Trade Commission's 1997 merger guidelines; and recent debates in the EU over possible adoption of the efficiency defence. The first major court case in which the efficiency defence succeeded was *Superior Propane* in Canada, in a series of tribunal and court decisions 2000-2003.

4 The Commission's first monopoly pricing inquiry under Part IV of the Commerce Act 1986 involved airfield charges. The final report, in August 2002, found evidence of monopoly profits being taken but did not directly address the public benefit test for two reasons. Firstly, the Commission used average-cost pricing as the "efficient price" benchmark for evaluating monopoly profits (Commerce Commission 2002 paragraphs 88 and 94) and on this basis the actual prices charged could be condemned as "allocatively inefficient". Secondly, the Commission's terms of reference for the airfields inquiry were to evaluate, under s.52 of the Commerce Act 1986, whether benefits to acquirers outweighed the costs of regulatory intervention. In contrast, its terms of reference for the gas pipelines inquiry extended to application of the public benefits test under s.56 of the Act.

1.2 A Brief History of the New Zealand Policy Debate 1986-1994

The Commerce Act 1986 empowered the Commission to authorise mergers and trade practices provided that they "will result, or be likely to result, in a benefit to the public which would outweigh the lessening of competition…".[5]

From the moment the Act came into force a strong lobbying effort was mounted by neoliberal proponents of the Chicago School position, arguing that the Act's objectives should be strictly limited to the promotion of economic efficiency, and that the ambiguous concept of "benefit to the public" in the statute should be tightened up to oblige the Commerce Commission to adopt the total surplus standard approach when assessing public benefit of mergers.

A major Business Round Table publication (Begg et al 1988) argued (p.117) that "the Commission's very wide interpretation of public benefit significantly increases the risk that the Act will be used to pursue a myriad of different objectives, the great majority of which would be achieved at lower cost through more direct instruments of government policy". Begg et al applauded (pp. 123 and 125) the Commerce Commission's *Cooperative Dairy* decision which rejected "a distributional objective for antitrust policy", and called for objectives other than "economic efficiency" to be stripped out of interpretations of the Commerce Act.

Similar views were set out in Vautier (1987), Jennings and Vautier (1988), and Jennings and Begg (1988), and were the subject of vigorous debate in the media between Douglas Greer (at the time a visiting fellow at NZIER) and Roger Kerr of the Business Round Table).[6] Greer's arguments against the Chicago school position were subsequently set out in Greer (1988).

At the same time the Department of Trade and Industry released a discussion paper reviewing the Commerce Act which pointed to apparent inconsistencies in the Commerce Commission's approach to what may constitute a public benefit, and suggested that "It is timely to consider whether the wider concept should be replaced with a test which is directed more towards economic benefit and more particularly some concept of economic efficiency" (DTI 1988 p.59).

In 1990 the Commerce Act was amended by addition of a new section 3A which directed the Commerce Commission to consider efficiency: "Where the Commission is required under this Act to determine whether or not, or the extent to which, conduct will result, or will be likely to result, in a benefit to the public, the Commission shall have regard to any efficiencies that the Commission considers will result, or will be likely to result, from that conduct". While raising the profile of "efficiency", this amendment left open the question of whether and what other elements of public benefit were to be considered. A submission on the amendment bill from the Business Round Table attacked the Commission for

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[5] For a review of interpretations of the term "public benefit" up to 1991 see Van Roy 1991 paragraph 1060 pp.246-251.

[6] See *National Business Review* articles by Roger Kerr (19 July 1988 p.8 and 18 August 1988 p.13) and Douglas Greer (2 August 1988 p.7 and 18 August 1988 p.14), and "Media Wqatch" commentary by Keith Ovenden in *NBR* 2 Septemver 1988.

not "limit[ing[] its analysis to efficiency" (BRT 1990 p.10 para 4.18), suggested that the Commission's views on public benefit had shifted with the personal views of the Commission's membership, and called for the public benefits test to be tightened up to block the Commission from taking a wider view of public benefits – including weighting benefits according to who received them (BRT 1990 p.12 para 4.25).

In August 1991 Cabinet agreed to a review of the Commerce Act which was to include explicit consideration of the scope of the public benefit test. A subsequent discussion paper from the Ministry of Commerce (1991 pp.9-19) devoted an entire chapter to the public benefit test and drew a distinction between a "wider" test (taking account of a range of criteria, potentially including distribution) and a "narrow" one focused solely on efficiency. The paper noted that the High Court in *Telecom Corporation v Commerce Commission and Ors* (Wellington Registry AP No 279/90, 10 December 1991) had ruled that "incorporation of distributive values of New Zealand society in the assessment of public benefit is not ruled out" (MOC 1991 p.13). The paper pointed out that the *status quo* was to use the wider test, and that the narrower test "has no legislative history in New Zealand", although the efficiency exception in the Canadian Competition Act 1986 might provide a precedent. No firm recommendations were made.

Following extensive further consultation and submissions a joint paper was issued in late 1992 by four key departments (Ministry of Commerce, Treasury, Justice and Department of Prime Minister and Cabinet) which reported ":a consensus in the review team and among those consulted that the efficiency gains and losses associated with a merger or practice are the principal consideration in the application of the public benefit test" (p.6) and produced a majority recommendation that (p.7 paragraph 2.14) "in order to remove doubt and to avoid possible future deviation by the Courts or the Commission the Act should be amended to ensure that the principal role of efficiency analysis in the authorization process is explicit."

The document then proceeded to address the crucial issue of how wealth transfers from consumers to producers ought to be evaluated under the public benefit test. The Act was said to be silent on this. There was acknowledged to be "no consensus in the economic literature on whether to take into account transfers from consumers to producers arising from a merger or practice, and, if so, what weighting to give to them" (p.11), and "there is no reliable economic basis for assessing the relative value of resources in the hands of different individuals. Ultimately such comparisons require a value judgment which we believe to be more appropriately a matter for policy makers than the Commission or courts" (p.11). From this the review team moved directly to the conclusion that "the best approach is to value resources in the hands of consumers and producers equally" (p.12 para 2.42), and to the recommendation that "no account is taken of the identity of those who gain the benefits if the benefits accrue to New Zealand" (p.13 para 2.52). Translated, this meant that the transfer of a dollar from consumers to producers has no net impact from the standpoint of society's welfare, and so should be ignored when making decisions on mergers.

In a hard-hitting and extensive dissent, the Department of Justice set out arguments which are all the more pertinent when read in 2003 against the background of the recent Canadian *Propane* decisions and the ongoing Part IV inquiries into New Zealand electricity and gas network industry profits. The Department complained that: "Under the guise of 'clarifying' the law and preventing future departures from the current interpretation of section 3A [the majority, led by Treasury] seeks to make significant changes to the test and to shift the focus and effect of the Act as a whole" (MoC et al 1992 p.15 para 2.55). The Department argued that social, environmental and wealth-distributional matters should remain in the test, that the precise meaning of "efficiency' had not been clearly spelled out, that "a statutory instruction to the courts and the Commission to ignore the identity of beneficiaries of gains … could be detrimental to the public and to the economy, particularly where the goods or services to be supplied are essential" (p.16 para 2.59), and that a concept allegedly directed to measuring "detriments and benefits to consumers" was "difficult to reconcile with a rule that would preclude decision makers from identifying the beneficiaries of efficiency gains" (p.16 para 2.60).

The Department addressed directly the issue now raised by the 2003 gas pipeline inquiry: "The idea of valuing resources in the hands of consumers and producers equally could turn monopoly profits into benefits particularly as it would no longer be necessary to show a benefit to the public. Do monopoly profits benefit New Zealand? Most applications for anticompetitive mergers and trade practices are likely to result in very substantial benefits to the companies applying for authorisation. If that is all that is required to displace the pro-competition premise of the Act, the question arises whether the time and expense of a Commission investigation … will still be justified" (p.17 para 2.61).

On 16 February 1993 Philip Burdon, as Minister of Commerce, announced Cabinet's decisions resulting from the review. These included a proposed amendment to section 3A of the 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". These promised amendment to the statutory wording were never implemented (possibly because parliamentary assent was far from certain). However, the injunction from Cabinet to give equal weight to consumers and producers (the "total surplus standard"), thus excluding wealth transfers altogether from the public benefit test, was quickly implemented by the Commerce Commission in its 1994 merger guidelines (see below).

The common thread through the public debates of 1988-93 was a relentless lobbying drive by proponents of the Chicago School, headed by Treasury and the Business Round Table, to narrow down the "public benefits test' in a direction that would exclude consideration of any issues other than the three categories of economic efficiency (allocative, productive and dynamic). The lobbying campaign failed to achieve its goal of unambiguous statutory wording that would mandate the total surplus standard, but achieved its main objective by administrative means when Cabinet approved, and the Commerce Commission adopted, an interpretation of the public benefit test which excluded social,

environmental, or so-called "distributional" considerations from Commerce Commission decision-making on mergers and trade practices. An arguable view is that this amounted to a neoliberal hijacking of the statute, reading it in a way that was almost certainly far narrower than Parliament intended.

Once the public benefit test had been thus restricted to narrowly-defined efficiency, the extension of the resulting total surplus standard to evaluation of the social impact of monopoly profits per se followed logically. This extension has now been formally made part of the Commission's 2003 gas pipelines inquiry framework. The Commission is thereby committed to the position that society is indifferent to the level of monopoly profits secured by price-gouging consumers, provided only that no economic inefficiency occurs.

A standard, long-standing response to the Chicago School is that first-degree price discrimination in theory would enable a monopolist to extract all consumer surplus from its customers without causing any allocative efficiency detriment (see, e.,g., Greer 1988). Thus the level of monopoly profit (the size of the wealth transfer from consumers) can potentially be varied at will by the monopolist with no effect on short-run efficiency. It is implausible to suppose that "society" is in fact indifferent between high and low levels of monopoly profit under these conditions, but this is the position into which the New Zealand authorities have become trapped by their guidelines.

1.3 Do Economists have Anything to Say About Bare Transfers?

Much of the material to be reviewed in the remainder of this paper relates to the impact of monopoly profit-taking for the dynamic efficiency of the economy in the long run. Many of the issues to be covered are commonly dismissed as "non-economic" or "merely distributional" in discussions of the so-called efficiency defence. An enormous and inconclusive economic literature exists on whether or not economists are in a position to make meaningful calculations of social welfare, and in particular to make interpersonal welfare comparisons. Many authors conclude from the lack of agreement over this issue that economists necessarily must abdicate from considering "distributional" matters, because these are properly to be decided by the political process, and separate from antitrust decision-making per se.

A premise of this paper is that whether or not economists can weigh 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 economic efficiency properties of competitive (as distinct from monopoly) prices, and the detrimental effects of excess wealth transfers from consumers to producers. A later section of this paper reviews some of the distribution-focused literature and concedes that an important part of the economics profession has allowed itself to become caught in an intellectual *cul de sac*; but the new-welfare-economics impasse can in fact be 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.

2. The Traditional View on Monopoly Rent

What I call the "traditional view" is that ownership of a monopoly does not confer an unrestricted right to exploit captive customers, and that some restraint on monopoly rents is therefore in the public interest. The monopolist is entitled to receive a fair and reasonable return on the resources committed, but no more. Profits above that level are legitimate only if explicitly sanctioned by due legal or legislative process. This basic principle is embodied in the common law of countries which inherited English legal precedents, including New Zealand. It provides one of the two pillars of the 1890 Sherman Act which is the basis for US anti-trust law and public-utility regulation. It prevailed in Canada, Australia and New Zealand at least up to the mid 1980s. It still prevails in the EU, including the UK. It also carries over into the theories of justice and the state advanced by political philosophers of the moderate left (Rawls 1971/1999), the new right (Nozick 1974), and the old right (Gray 1993).

2.1 Some Basic Economics: Supernormal Profit, Rent and Quasi-rent

Supernormal profit is the profit obtained, by the supplier of any good or service, over and above the full long-run economic costs of supply. In common with the return to owners of productive land, these profits are a sort of rent (income which accrues to the owner of some scarce factor of production simply by virtue of economic scarcity harnessed to the property right of the owner to charge what the market will bear).

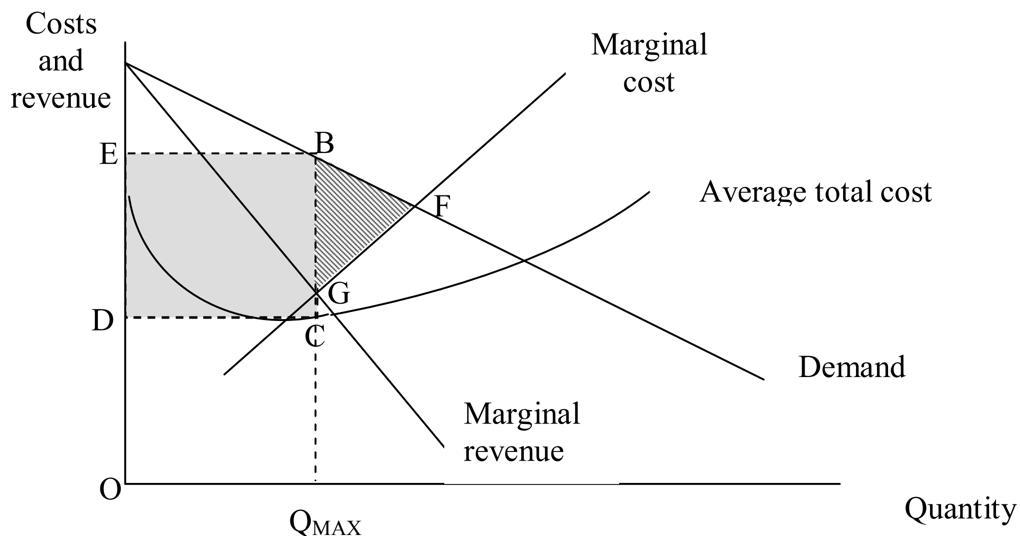
Under competitive conditions the rent on non-reproducible resources such as land is sustainable in the long run, whereas rents to other scarce but reproducible resources such as skill, specialised capital assets, and new technologies and products, are ephemeral, because entry of new competitors in due course drives down the price and hence erodes the profitability of the sector concerned. For example, a firm which manages to cut its costs relative to its competitors, whether by innovation or by reorganisation, will earn supernormal profits until others catch up. Similarly, all firms in a competitive market where rising demand causes shortages, and hence drives the price up, will temporarily earn supernormal profits until supply expands to meet to additional demand and the price returns to normal levels. Because they are ephemeral, these super-normal profits are called quasi-rents[7]. Where they reflect the reward for genuinely creative contributions to the material well-being of society at large, quasi-rents are positive features of the economic landscape and often enjoy official protection against premature erosion, through institutional devices such as the patents system.

[7] Marshall 1936 Book V Chapter 10 pp.426-428.

The defining characteristic of monopoly is its ability to exclude competitors from the market, and its consequent immunity from competitive pressures that would otherwise erode supernormal profits over time. Two particular varieties of monopoly are especially well protected from such erosion: state-granted (franchised) monopolies protected by law, and natural monopolies protected by economies of scale. In these cases, profits over and above the long-run cost of production are permanent rents, not temporary quasi-rents. They are appropriated by whichever party holds the relevant property rights, and any limitation on such appropriation is a limitation on the property right of the owner.

Most introductory economics textbooks include a section on monopoly, built around some variant of the diagram in Figure 1. Here deadweight loss ("allocative inefficiency") is shown by the triangle BFG. All writers agree that this inefficiency is a social detriment: because price is higher than it would be under perfect competition, quantity is lower, and society is deprived of potential economic surplus of BFG (made up of both producer surplus and consumer surplus foregone).

Figure 1



The monopolist's supernormal profit at the profit-maximising quantity Q_{MAX} is shown by the rectangle EBCD, and is generally described as comprising the amount that consumers are obliged to pay over and above the total cost of supplying the good. All the textbooks are agreed that this profit represents a transfer from consumers (acquirers) to the supplier, which leaves buyers of the good worse off, and suppliers better off, by equal monetary amounts.

Several points about the profit-maximising outcome deserve emphasis.

First, it is important to note that Figure 1 has been constructed on the assumption that a uniform price is charged for all units sold. However, in many cases monopoly prices can be structured in such a way as to cause no allocative

inefficiencies to arise, in the short run at least[8]. That is, there is no need (in the short run at least) for output to be restricted in order for monopoly profits to be taken. (Neoliberal writers such as Bork (1978) generally overlook this point. In mitigation, it is clear from several passages in Bork's book that his entire analysis, and the policy prescriptions drawn from it, has to be read as long-run, not short-run, in focus. Proponents of his arguments do not always bear this in mind.) The point here is that it is, in principle, possible to have monopolistic rent transfers from consumers to producers with no detriment to allocative efficiency in the short run.[9]

Second, the monopoly price OE is able to be charged only under the particular institutional conditions of a market economy in which no regulatory intervention interferes with the property right of the monopolist to "hold up" its customers for their full willingness to pay. In effect, customers confront a take-it-or-leave-it offer from the monopolist, their choices being reduced thereby to consuming the quantity Q_{MAX} at the price OE or going without the good or service.[10]

Third, this freedom of the monopolist to charge what the market will bear implies that some collective decision has been made, whether explicitly or implicitly, to include price-making market power in the bundle of legitimate property rights attaching to ownership of the monopoly enterprise and its specific assets. Figure 1 would require modification if, for example, a collective decision had been taken which restricted the property rights of private monopolists along the lines sketched earlier – namely that the prices charged be sufficient to recover the monopolist's average total cost, but no more. Such a collectively-agreed limitation on the rights of private property could lead to a variety of institutional arrangements (all familiar from real-world history). Two such arrangements can be quickly sketched, to illustrate the point.

Under one such arrangement the monopolist could continue to supply the quantity Q_{MAX} at price OE, but would be obliged to pay a lump-sum tax of EBCD which would be rebated to consumers[11]. The result would be to leave

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[8] Clearly in the long run, the details of tariff structure cease to be relevant, and what matters is the total cost to consumers of the service, from which flow various incentives in relation to investment and technology choice. These issues, while fundamental to dynamic efficiency in the full sense of the term, lie outside the Commerce Commission's analytical framework.

[9] Gas pipelines in New Zealand, for example, routinely charge two-part tariffs which approximate allocatively efficient pricing. They are probably as productively efficient as could be expected relative to international best practice. The industry is reasonably dynamically efficient, in the sense that investment funding is not critically constrained by current profit levels, and incentives to invest are limited primarily by the maturity of the existing networks and the various contractual and statutory distortions in the gas market, rather than by profitability *per se*. Monopoly profits in this industry, in other words, will pass the Commerce Commission's proposed public benefits test with flying colours unless attention is directed to the basic legitimacy of wealth transfers.

[10] "Going without", obviously, includes both the non-market option of self-supply by the individual consumer, and the use of imperfect substitutes purchased in separate markets. A large economic literature and substantial case-law on market definition explores the issue of the limitation placed on monopoly power by the existence of those substitutes; this need not detain us here, since the relevant considerations are incorporated into the position and slope of the monopolist's demand curve in Figure 1.

[11] See, e.g., Begg et al 1987 p.361.

consumers fully compensated for the wealth transfer implicit in the price OE, while the monopolist would be left with the full "fair return" on its costs of supplying Q_{MAX}. The tax imposes a ceiling on the monopolist's allowed profit, leaving otherwise intact the monopolist's rights of ownership of its assets (including the right to dispose of them at any time) and freedom to choose what quantity of the good it will supply, given the profit restraint. Collective decisions could obviously extend to variations on the lump-sum tax theme, including allowing the monopolist to retain some part of its monopoly profit (this would make sense if, for example, there was substantial uncertainty over the true level of average total cost).

An alternative arrangement is for the monopoly to be induced to follow a normal-profit strategy in place of the more familiar profit-maximisation goal. This is readily accomplished by vesting the relevant assets in collective ownership and instructing the management of the enterprise to earn a normal profit but no more. Such arrangements were the norm for natural monopolies in countries such as the UK, Australia and New Zealand over the century prior to 1980, following which there took place a wave of privatisation or corporatisation of state owned enterprise. (Privatisation vests the assets into private rather than public hands, with or without explicit legal or contractual restraints on subsequent profit-maximisation. Corporatisation changes the goals pursued by the managers of publicly-owned enterprises, from cost recovery to profit maximisation.)

At issue in the present discussion is the property right of a monopolist to appropriate the rent, EBCD, as a transfer to itself from its customers. The two next sections will argue that the question of whether such a transfer is good or bad from the public (social) point of view is inseparable from the issue of the actual content of legitimate property rights. This takes us into issues of political philosophy and procedural justice. Having confronted those issues, I shall proceed to argue that they are inescapable in the formulation of a public benefit test. From this it will follow that the "total surplus standard" cannot provide the basis for any public benefit test in merger analysis or natural-monopoly regulation, unless it is harnessed to some social welfare function to evaluate the net public benefits from wealth transfers. This conclusion is reinforced by a discussion of the well-known impasse in welfare economics over interpersonal comparisons, and will be illustrated by discussion of two recent cases in Canada (*Hillsdown* and *Superior Propane*). I then conclude by returning to the issues presently confronting New Zealand policymakers in relation to electricity networks, gas pipelines, ports, airports, roading, water and wastewater systems, and the telecommunications local loop.

2.2 Takings and Givings: Theft, Charity, Tax, Monopoly Rent, and Distributive Justice

A quick thought experiment highlights the reasons why it should be economically as well as legally desirable to place restrictions on the scope of private property rights, in situations where possession of property gives one citizen the power to injure others by taking their wealth. Possession of a gun, let

us suppose, gives the owner the ability to carry out a bank robbery. If the hold-up is successfully completed without injury and the bank is left able to continue in operation, then all that occurs is a bare transfer of wealth from the banker to the gun-owner. Yet most societies have legal prohibitions on robbery, and long-run macro-economic performance appears to correlate well with the effective enforcement of such laws. The micro-economic theory of pareto optimality, as will be seen below, provides no general guidance on whether society gains or loses from bare wealth transfers of the kind epitomised by bank hold-up; but few economists, lawyers or philosophers hesitate to support the existence of laws prohibiting such transfers.

If bank robbery is a good polar exemplar of the taking of property by the exercise of one person's power over another, the other end of the spectrum is the giving of voluntary donations to a charitable organization. Here again a bare wealth transfer takes place, but this time at the volition of the donor rather than the recipient, and without the exercise of power by either party. Here the law has traditionally been supportive; tax-deductions are common for charitable giving.

Between these two polar types of wealth transfers lies a spectrum of give-and-take, with both government taxation and the private taking of monopoly profits located somewhere along that spectrum.[12]

The usual practice in western society has been to view favourably the "giving" end of the spectrum and to outlaw the "taking" end. This inevitably implies that a distinction between acceptable and unacceptable wealth transfers must be drawn at some point.

The proposition that some wealth transfers are good and some are bad is pretty much common ground among moral and political philosophers of otherwise divergent views. To establish the point being made here, it seems appropriate to focus on the work of one of the most minimalist of those philosophers, Robert Nozick, whose central project in his 1974 book was to place limits on the legitimate extent of the state while arguing that "a minimal state, limited to the narrow functions of protection against force, theft, fraud, enforcement of contracts, and so on, is justified … and that the minimal state is inspiring as well as right." (1974 p.ix). Nozick argues that "a state would arise from anarchy (as represented by Locke's state of nature) even though no one intended this or tried to bring it about, by a process which need not violate anyone's rights" (1974 p.xi). The process by which this would occur is one of voluntary contracting among consenting individuals, to achieve by collective means the protection of certain individual rights which are inherent in Locke's "law of nature" and which are better taken care of through state institutions than through "feuds, … an endless series of acts of retaliation and exactions of compensation" (1974 p.11).

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[12] Historically there have been occasions when the granting of private monopoly privileges has been a direct substitute for taxation, as in the tax farms of seventeenth-century France; in such arrangements the state took payment from the monopolist for the privilege, and then legitimised its collection of monopoly profits on commodities such as salt. Insofar, therefore, as monopolies exploit their customers under direct licence from government, taxes and monopoly profits can be located at the same point on the give-and-take spectrum.

Nozick summarises key elements of Locke's position as follows (1974 p.10):

> The bounds of the law of nature require that "no one ought to harm another in his life, health, liberty or possessions".... Some persons transgress these bounds, "invading others' rights and … doing hurt to one another," and in response people may defend themselves or others against such invaders of rights… The injured party and his agents may recover from the offender "so much as may make satisfaction for the harm he has suffered"…; "everyone has a right to punish the transgressors of that law to such a degree as may hinder its violation"; each person may, and may only, "retribute to [a criminal] so far as calm reason and conscience dictate, what is proportionate to his transgression, which is only so much as may serve for reparation and restraint."

The "minimal state" to which Nozick attributes moral legitimacy, and which he shows to violate no individual's rights, possess two characteristics: a state monopoly over the use of force within the relevant territory, and the fact of "protect[ing] the rights of everyone in the territory, even if this universal protection could be provided only in a 'redistributive' fashion" (1986 p.113).

The individuals responsible for operating the state are, in Nozick's view, under a moral imperative which he assumes will be obeyed[13]: "The dominant protective association with the monopoly element is morally required to compensate for the disadvantages it imposes upon those it prohibits from self-help activities against its clients." (In terms of welfare economics, this implies that actual compensation must be paid to the losers from any change implemented to realize a "potential pareto improvement" – the mere feasibility of hypothetical compensation will not suffice unless the losers themselves have voluntarily agreed to forego their right to compensation.)

The crucial part of Nozick's book for our purposes is his conception of distributive justice in Chapter 7 section 1 (1986 p.151):

> If the world were wholly just, the following inductive definition would exhaustively cover the subject of justice in holdings:
>
> 1. A person who acquires a holding in accordance with the principle of justice in acquisition is entitled to that holding
> 2. A person who acquired a holding in accordance with the principle of justice in transfer, from some else entitled to that holding, is entitled to the holding.
> 3. No one is entitled to a holding except by (repeated) application of 1 and 2.

[13] "We have assumed that generally people will do what they are morally required to do" (1986 p.119). The consequences if this assumption does not hold are not explored, but would seem to be a morally-legitimate reversion of the society concerned into a state of anarchy.

Both of the first two items in Nozick's list come into play in relation to natural monopolies. The principle of justice in acquisition includes, and is limited by, the "Lockean proviso": "A process normally giving rise to a permanent bequeathable property right in a previously unowned thing will not do so if the position of others no longer at liberty to use the thing is thereby worsened" (1986 p.178). The implications for abuse of a monopoly position are immediate (1986 pp.179-180):

> A theory which includes this proviso in its principle of justice in acquisition must also contain a more complex principle of justice in transfer. Some reflection of the proviso about appropriation constrains later actions….
> …
> Each owner's title to his holding includes the historical shadow of the Lockean proviso on appropriation. This excludes his transferring it into an agglomeration that does violate the Lockean proviso and excludes his using it in a way, in coordination with others of 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.
>
> Notice that the theory does not say that owners do not have these rights but that the rights are overridden to avoid some catastrophe... There is no such external … overriding. Considerations internal to the theory of property itself, to its theory of acquisition and appropriation, provide the means for handling such cases….
>
> [T]he Lockean proviso is not an "end-state principle"; it focuses on a particular way that appropriative actions affect others…

Nozick's discussion of the Lockean proviso arguably underestimates how far-reaching its implications are in a modern society[14] - especially a small economy such as that of New Zealand, where many markets can support only one or a few suppliers of efficient scale.

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[14] "I believe that the free operation of a market system will not actually run afoul of the Lockean proviso …. [T]he proviso will not play a very important role in the activities of protective agencies and will not provide a significant opportunity for state action."(1986 p.182). He adds, however, that "Here I make an empirical historical claim; as does someone who disagrees with this" (p.182).

Nozick lays out some exclusions from the proviso that have resonance in recent New Zealand cases. Those familiar with the "efficient component pricing rule" ("Baumol-Willig Rule) advanced in *Telecom v Clear* will find resonance in Nozick's clear statement that (1986 p.178) the proviso "does not include how I 'worsen' a seller's position if I appropriate materials to make some of what he is selling, and then enter into competition with him". Possessors of intellectual property rights will find a defence of (time-limited) patent protection for inventors (1986 pp.181-182). And the general point is made that (1986 p.178) "someone whose appropriation otherwise would violate the proviso still may appropriate provided he compensates the others so that their situation is not thereby worsened" – clearly the remedy that comes most easily to the mind of a Nozickian when faced with monopoly pricing (cf the tax-and-rebate option discussed earlier in the context of Figure 1).

It is important to bear in mind that Nozick's strictures against the abuse of a monopoly position do not constitute part of his discussion of redistribution of income in pursuit of other political goals such as equality. Not surprisingly, he is hostile to such redistribution and devotes an extensive section (1986 pp.183-231) to a frontal assault on Rawls' theory of justice and other proposals for socialistic redistribution. Nozick does not regard monopoly rent transfers as a distributional issue to be separated off from the property rights of the monopolist and dealt with as part of a state-sponsored scheme of income redistribution. Monopoly rent transfers are squarely in focus as a coercive taking of one citizen's holdings by another, and their condemnation by Nozick rests upon the violation of his principle of justice in acquisition – not upon any distaste for income inequality or belief that some individuals are more "deserving" than others. "My property rights in my knife allow me to leave it where I will, but not in your chest" (1986 p.171).

It goes without saying that philosophers less minimalist than Nozick in their conception of the legitimate realm of state activism will have no difficulty accepting his conclusions regarding the illegitimacy of monopolistic taking of any citizen's wealth. Few if any major philosophers are to be found with a more minimalist position than Nozick's. Consequently, any attempt to argue that the government ought to be neutral in the face of transfers of monopoly rent – that losses to consumers ought to be weighed equally against the gains to suppliers – faces a burden of proof rather higher than seems to have been appreciated by the numerous economists and lawyers recently engaged in promotion of the "naïve version"[15] of Williamson's (1968) efficiency defence. (The recent history of the efficiency defence is discussed below.)

The foregoing discussion indicates that the proposition which underpins the total surplus standard and the Commerce Commission's public benefits test - that all wealth transfers are essentially the same ("a dollar is a dollar") - is simply not philosophically sustainable in a contractarian framework. Where Nozick goes so boldly, less minimalist souls need not fear to tread.

[15] The term "naïve" is Williamson's own – 1968 p.21.

A wealth transfer carried out in accordance with the free wish of the donor party (a charitable donation) is not to be compared on the same metric as one which is forced upon the victim against that person's will (a bank robbery or, as in Nozick p.150, a fraud). Transfers located between these extremes will have to be ranked if we are to find the appropriate dividing-line between those transfers which satisfy and those which violate the Lockean proviso. Clearly, as was indicated earlier, a natural monopolist which fully compensates its customers for any damage they may suffer due to the non-existence of even a hypothetical competitive market, will fall into the legitimate part of the spectrum. A monopolist which simply takes what the market will bear, and in the process extorts unwarranted bare transfers of wealth from its customers, may not.

2.3 A Brief Formal Statement

Some explicit or implicit welfare ranking across various procedural types of transfers, of the sort outlined in the previous section, is universally applied in real world societies, with the "public benefit" of any transfer decreasing as the degree of holdup (coercion) increases:

$$W = W(H) \qquad W' < 0$$

where W is the net social benefit arising from a dollar's worth of wealth transfers and H is an index of the degree of holdup (coercion) involved in the transaction.

Holdup here is not an uncomplicated variable. It comprises some weighted sum of the extent of the power exercised by the wealth taker, the extent to which that power is actually exercised, the extent to which exercise of that power contributes to the wider good of society, and (relatedly) the extent to which the exercise of that power has been legitimated and regulated by some democratic process of consent.

Governments possess greater power to take wealth than any other group in society. When exercised responsibly, with moderation, with due parliamentary consent, and for the purpose of financing collectively-desired activities, the act of taxation involves a relatively low value of H and a high value of W. Monopoly control of an essential facility, similarly, can be associated with low H and high W if no more than normal competitive levels of profit are taken, since the users of the relevant service obtain the desired benefits in exchange for payment of no more than the economic cost of supply. In contrast, either rapacious taxation by dictators, or unrestrained taking of consumer wealth by natural monopolists, imply high H and low W. A well-designed rule of law sets and enforces appropriate limits on H, and in the process places firm limits on the rights of private property, as a means of moving society to higher levels of W.

As an aside, it should be noted that the units in which W is measured have not here been specified. While utilitarians may cheerfully opt for utility, other metrics are fully acceptable. Many writers in the economic development

literature, for example, speak of social consensus and hence cohesion as major components of the "good society"[16].

2.4 *Predation, Diversion, Rent-Seeking and Incentives: Institutional Factors in Economic Development*

Adam Smith declared the minimum institutional requirement for the achievement of 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. Those institutional requirements include sanctity of contract and secure property rights, both of which enable the creators of wealth to appropriate as reward the fruits of their efforts, by placing restraints on the taking of wealth, whether by government or by private monopolies.

Many economists and economic historians since Smith have argued the fundamental importance of the triad of secure property rights, sanctity of contract, and the rule of law, in determining long run economic performance. 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 in the form of a competitive return on their investments and a fair reward for their labour and entrepreneurship. A redistribution of income and wealth which takes from those businesses part of what would otherwise have been their profits, and transfers that wealth into the hands of other private interests simply by virtue of the fact that those interests enjoy monopoly control of facilities which are essential to "the ordinary business of life" (Marshall's phrase) is in effect a tax on the profits of competitive businesses. The disincentive effects of the taking of monopoly rents are the same as those of direct taxation, and the same arguments for restraint apply.

Note that the argument here is a pragmatic one from empirical intuition and experience. It is separable from the philosophical issue of distributive justice discussed earlier. Which institutional arrangements have proven functionally effective in creating incentives for investment and growth is a question best answered from the historical record.

Both economic theory and the preponderance of evidence from history and from econometric analysis of cross-country growth data point to the conclusion that countries' economic growth performance is inversely related to the extent of economic predation faced by ordinary citizens. The world's most successful economies in the past millennium have been those which have struck the right balance between the extension and protection of private property rights on the

[16] Easterly (2002) for example devotes a chapter to the apparently robust negative correlation between ethnic and/or class inequality and key developmental attributes such as GDP per capita, growth, education and health status, and freedom from civil strife.

one hand, and the imposition of explicit limitations on those property rights, enforced by the rule of law, on the other. Unwarranted wealth transfers such as the taking by private monopolies of part of the property of competitive businesses, by a process of holdup, map out part of the boundary between those economies in which competitive business is secure from expropriation, and those in which it is not. Freedom from expropriation seems, on the record, to be observably good for economic growth, and vice versa.

At the most general historical level Douglass North[17] has emphasised the centrality in western 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, in a recent econometric study of cross-country productivity differentials, argue that[18]

> 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[19] have developed the Classical economists' view that "monopoly power impedes economic progress".

17 North, D.C. and Thomas, R.P., *The Rise of the Western World: A New Economic History*, Cambridge University Press, New York, 1973; North, D.C., *Institutions, Institutional Change, and Economic Performance*, Cambridge University Pres,. New York, 1990.

18 Hall, R.E. and Jones, C.I., "Why Do Some Countries Produce So Much More Output Per Worker Than Others?", *Quarterly Journal of Economics* 114: 83-116, 1999, p.84.

19 Parente, S.L. and Prescott, E.C., "Monopoly Rights: A Barrier to Riches", *American Economic Review* 89(5): 1216-1233, p.1216

Acemoglu et al[20] 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[21], Stiglitz[22], Barro[23], Olson[24], Engerman and Sokoloff[25], and Rodrik et al[26] 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. A separate literature by authors including Posner[27], Tullock[28], Buchanan[29], Krueger[30], and Rogerson[31] focuses on the drag to economic performance that results from diversion of society's scarce resources from productive activity to unproductive rent-seeking when institutional arrangements are open to capture and private monopoly rents can be secured by such capture.

2.5 The Common Law and the Doctrine of Prime Necessity

Included in the institutional legacy that accounts for the superior long-run economic performance of settler colonies such as the USA, Canada, Australia, New Zealand and South Africa was their inherited common-law tradition of protection for the powerless against the powerful, including the doctrine of prime

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[20] Acemoglu, D., Johnson, S. and Robinson, J.A., "Reversal; of Fortune: Geograpohy and Institutions in the Making of the Modern World Income Distribution", *Quarterly Journal of Economics* 117(4): 1231-1294, November 2002, p.1235.

[21] Easterly, W., *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, MIT Press, 2002.

[22] Stiglitz, J., *Globalization and its Discontents*, Allen Lane, 2002.

[23] Barro, R.J., *Determinants of Economic Growth*, MIT Press 1999.

[24] Olson, M., *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships*, Basic Books, New York, 2000.

[25] Engerman, S.L. and Sokoloff, K.L., "Institutions, Factor Endowments, and Differential Paths of Growth Among New World Economies", *Journal of Economic Perspectives* 14 (3): 217-232, Summer 2000.

[26] Rodrik, D., Subramanian, A. and Trebbyi, F., "Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development", NBER Working Paper 9305, October 2002.

[27] Posner, R., "The Social Costs of Monopoly and Regulation", *Journal of Political Economy* 83: 807-827, 1975.

[28] Tullock, G., "The Welfare Costs of Tariffs, Monopolies, and Theft", *Western Economic Journal* 5: 224-232, June 1967, reprinted as Chapter 3 in Buchanan, J.M., R.D. Tollison, and G. Tullock (eds) *Toward a Theory of the Rent-Seeking Society*, Texas A&M Press 1980; Tullock, G., *The Economics of Special Privilege and Rent Seeking* , Kluwer Academic Publishers 1989.

[29] Introduction to Buchanan, J.M., R.D. Tollison, and G. Tullock (eds) *Toward a Theory of the Rent-Seeking Society*, Texas A&M Press 1980.

[30] Krueger, A.O., "The Political Economy of the Rent-Seeking Society", *American Economic review* 64: 291-303, June 1974.

[31] Rogerson, W.P., "The Social Costs of Monopoly and Regulation: A Game Theoretic Analysis", *Bell Journal of Economics and Management Science* 13: 391-401, Autumn 1982.

necessity which dictates that essential facilities must not be used for purposes of holdup.

In *Munn v. State of Illinois*[32] the court's decision pivoted on the distinction between two categories of private ownership - "public franchise" and private. Property granted as a "public" franchise or license was subject to regulation of rates charged and services provided to the public. Public franchises included proprietorship of "common carriers" such as ferries; "public ways" or roads; "public warehouses"; "public houses"; and public wharfs. Relating to the essential public nature of the use, the owner was held to "exercise a sort of public office" - a 'public calling'" and have public duties to perform as contrasted with those using private property in the normal competitive arena of "ordinary business pursuits" (contract) or for their own personal enjoyment.

The Court summarized thus the common law background:

> 'A body politic', as aptly defined in the preamble of the Constitution of Massachusetts, 'is a social compact by which the whole people covenants with each citizen, and each citizen with the whole people, that all shall be governed by certain laws for the common good.' This does not confer power upon the whole people to control rights which are purely and exclusively private … ; but it does authorize the establishment of laws requiring each citizen to so conduct himself, and so use his own property, as not unnecessarily to injure another. This is the very essence of government, and has found its expression in the maxim *sic utere tuo ut alienum non laedas*. From this source come the police powers, which, as was said by Mr. Chief Justice Taney in the License Cases, 5 How. 583, 'are nothing more or less than the powers of government inherent in every sovereignty, . . . that is to say, . . . the power to govern men and things.'
>
> Under these powers the government regulates the conduct of its citizens one towards another, and the manner in which each shall use his own property, when such regulation becomes necessary for the public good. In their exercise it has been customary in England from time immemorial, and in this country from its first colonization, to regulate ferries, common carriers, hackmen, bakers, millers, wharfingers, innkeepers, etc., and in so doing to fix a maximum of charge to be made for services rendered, accommodations furnished, and articles sold. To this day, statutes are to be found in many of the States relating to some or all these subjects; and we think it has never yet been successfully contended that such legislation came within any of the constitutional prohibitions against interference with private property.
>
> In *Aldnutt v. Inglis*, 12 East, 527, decided in 1810, it appeared that the London Dock Company had built warehouses in which wines were taken in store at such rates of charge as the company and the owners might agree upon. Afterwards the company obtained authority, under the

32 [1876] 94 U.S. 113.

general warehousing act, to receive wines from importers before the duties upon the importation were paid; and the question was, whether they could charge arbitrary rates for such storage, or must be content with a reasonable compensation. Upon this point Lord Ellenborough said (p. 537):--

"'There is no doubt that the general principle is favored, both in law and justice, that every man may fix what price he pleases upon his own property, or the use of it; but if for a particular purpose the public have a right to resort to his premises and make use of them and he have a monopoly in them for that purpose, if he will take the benefit of that monopoly, he must as an equivalent, perform the duty attached to it on reasonable terms. The question then is, whether, circumstanced as this company is, by the combination of the warehousing act with the act by which they were originally constituted, and with the actually existing state of things in the port of London, whereby they alone have the warehousing of these wines, they be not, according to the doctrine of Lord Hale, obliged to limit themselves to a reasonable compensation for such warehousing. And, according to him, whenever the accident of time casts upon a party the benefit of having a legal monopoly of landing goods in a public port, as where he is the owner of the only wharf authorized to receive goods which happens to be built in a port newly erected, he is confined to take reasonable compensation only for the use of the wharf.'"

..."This brings us to inquire as to the principles upon which this power of regulation rests, in order that we may determine what is within and what without its operative effect. Looking, then, to the common law, from whence came the right which the Constitution protects, we find that when private property is 'affected with a public interest, it ceases to be *juris privati only'*. This was said by Lord Chief Justice Hale more than two hundred years ago, in his treatise *De Portibus Maris, 1 Harg. Law Tracts, 78*, and has been accepted without objection as an essential element in the law of property ever since. Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use, but, so long as he maintains the use, he must submit to the control."

"Thus, as to ferries, Lord Hale says, in his treatise *De Jure Maris*, 1 Harg. Law Tracts, 6, the king has 'a right of franchise or privilege, that no man may set up a common ferry for all passengers, without a prescription time out of mind, or a charter from the king. He may make a ferry for his own use or the use of his family, but not for the common use of all the king's subjects passing that way; because it doth in consequence tend to a common charge, and is become a thing of public interest and use, and

> every man for his passage pays a toll, which is a common charge, and every ferry ought to be under a public regulation, viz., that it give attendance at due times, keep a boat in due order, and take but reasonable toll; for if he fail in these he is finable.' So if one owns the soil and landing-places on both banks of a stream, he cannot use them for the purposes of a public ferry, except upon such terms and conditions as the body politic may from time to time impose; and this because the common good requires that all public ways shall be under the control of the public authorities. This privilege or prerogative of the king, who in this connection only represents and gives another name to the body politic, is not primarily for his profit, but for the protection of the people and the promotion of the general welfare.
>
> "And, again, as to wharves and wharfingers, Lord Hale, in his treatise *De Portibus Maris*, already cited, says:--
> "'A man, for his own private advantage, may, in a port or town, set up a wharf or a crane, and may take what rates he and his customers can agree upon for cranage, wharfage, housellage, pesage; for he doth no more than is lawful for any man to do, viz., makes the most of his own ...If the king or subject have a public wharf, unto which all persons that come to that port must come and unlade or lade their goods as for the purpose, because they are the wharfs only licensed by the queen,...or because there is no other wharf in that port, as it may fall out where a port is newly erected; in that case there cannot be taken arbitrary and excessive duties for cranage, wharfage, pesage, etc., neither can they be enhanced to an immoderate rate; but the duties must be reasonable and moderate, though settled by the king's license or charter. For now the wharf and crane are affected with a public interest, and they cease to be juris privati only; as if a man set out a street in new building on his own land, it is now no longer bare private interest, but is affected by a public interest.'"

This approach in principle to the limitation of private property rights in the case of essential facility monopolies remains central to US debates about the limitations which are legitimately placed upon individual rights for the common good.

The "doctrine of prime necessity", as it has come to be known, is generally agreed to have formed part of the common law of New Zealand at least up to the passage of the Commerce Act 1986, but since then all attempts to secure redress through the courts against monopoly pricing have failed, on the basis that the courts consider that they no longer have power to control prices or profits because the power to impose regulation has been reserved to various Ministers of the Crown, by means of Orders in Council under Part IV of the Commerce Act.

As the Privy Council stated in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385 :

> 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.

Part I of the Act establishes the Commerce Commission. Part II deals with restrictive trade practices. … Part IV deals separately with control of prices…. Therefore 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***." [Emphasis added.] (p.404)

…

"The Court of Appeal took the view that s.36 had the wider purpose, beyond producing fair competition, of eliminating monopoly profits currently obtained by the person in the dominant market position. Their Lordships do not agree." (p.407)

…

"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." (p.408)
…
"[T]he elimination of … monopoly rents is (otherwise than by competition) within the province of Part IV of the Act." (p.408).

The New Zealand Court of Appeal has since confirmed, in *Vector Ltd v Transpower New Zealand Ltd* [1999] 6 NZBLC 99-482, that (in the judgment by Richardson P)

[51] We consider that in principle and on the authorities what may be called the common law doctrine of prime necessity came to form part of the common law of New Zealand…. [T]he doctrine embodies a principle that monopoly suppliers of essential services must charge no more than a reasonable price."
…
[52] There are two questions for consideration. The first is whether the common law rule has been displaced in whole or in part by statute … The second and related question concerns the impact of that displacement on the common law principle…[T]he common law may survive unutilised while the statute remains in force and spring up on its repeal…

[53] As it is graphically put in Bennion, *Statutory Interpretation*, 3rd ed., 133:

> *Effect on existing law:* To describe the way Acts operate on existing law one can use the image of a floor upon which rugs are spread. The floor consists of unwritten law …, in other words common law, rules of equity, and customary rules. The Act conceals, for the area it covers, the texture underneath. …
> To complete the metaphor, the rug and the floor must run the same way…. The statute serves similar goals to the common law rule." [Emphasis added]
> …
> "[59] For reasons we can express quite shortly we are satisfied that there is no room for the operation of the common law doctrine in relation to the transmission of bulk electricity…
> …
> [61] … If upheld in this case prime necessity would involve heavy-handed regulatory intervention on Transpower's pricing, through the courts and potentially on a day to day basis… and to do so would be inconsistent with the purpose and scheme of the *Commerce Act*.
> …
> [62] … The only State control of prices contemplated by the legislation is provided for within Part IV…
> …
> [64] In short, it is inherent in those features of the statutory scheme that Part IV is the exclusive means of achieving price control over the transmission of bulk electricity by Transpower…. [T]here is no control under s.36 over monopoly rents, the Privy Council seeing their elimination in the short run as falling within the province of Part IV"

This interpretation has subsequently formed the basis of the High Court decision in *Metrowater Ltd v Gladwin* [2000] 6 NZBLC 99-487 and the Appeal Court decision in *Pacifica Shipping Ltd v Centreport Ltd* [2002] CA279/01.

As the passages emphasised above make clear, the courts have held that the ***procedure*** of applying the common law principle through the courts has been extinguished by the Commerce Act[33], but that the ***principle*** that a monopolist should not charge extortionate prices for access to an essential facility carries over to the new price-control machinery embodied in Part IV: "the statute serves similar goals to the common law". The existence of a scheme of regulation under Part IV was an essential premise upon which the Privy Council decision in *Telecom v Clear* rested. Had Part IV not existed, and had it not provided the protection against monopoly hold-up which the Privy Council interpreted it as providing, it would arguably not have been possible for the Council to find that

[33] It is, incidentally, not at all clear that the Commerce Act really marked the key change in the legal situation. Arguably the 1986 Act is no more restrictive on the ability of the courts to hear monopoly pricing cases than was its 1975 predecessor; yet the common law doctrine continued to be taken for granted by the courts throughout the 1980s – the Privy Council ruling in *Telecom-Clear* was a considerable shock to the legal profession as well as to politicians and the general public. While the Privy Council was presumably aware that it was declaring the common law to have been eclipsed by the statute, that case was not argued in terms of the common law doctrine and the issue is not explicitly addressed in the judgment, leaving it to the New Zealand Court of Appeal in *Vector v.Transpower* to draw out the full implications.

s.36 of the Act did not extend to the issue of pricing. Otherwise no avenue would have existed for application of the enduring common law principle.

Parliament's awareness of this issue was evident in Schedule 1 of the Telecommunications Act 2001 which directed the Commerce Commission, in regulating interconnection charges for natural-monopoly local-loop facilities, to set to one side a pricing scheme (the Efficient Component Pricing Rule, ECPR, also known as the Baumol-Willig Rule) which was "economically efficient" but had the effect of cementing-in monopoly profits. Parliament in that Act instructed the Commission that the price of interconnection should be not less than zero (pure "bill-and-keep") and not greater than Total Service Long Run Incremental Cost (TSLRIC). These provisions were prefaced by the words "to avoid doubt" (*Telecommunications Act 2001* Schedule 1 Part 1 Subpart 1 section 2(1)).

The "doubt" which Parliament was anxious to "avoid" would seem to have related to the issue here, namely whether the Commerce Act's obvious focus on the promotion of economic efficiency should be interpreted as providing a defence to shield the excess profits of natural-but-efficient monopolies, or whether in fact the intent of the statute is that Part IV should serve "similar goals to the common law", namely (in this case) the protection of the interests of acquirers of monopoly services.

The Commission's 2003 *Gas Framework Paper*, insofar as it argues that a public benefits test contradicts the doctrine of prime necessity by treating excess profits secured by holdup as having no net public detriment, is not easily reconciled with the position of the courts in the cases cited above, which is that Part IV was intended to give protection to acquirers; nor with the implication which follows, that Parliament in enacting the Commerce Act 1986 considered that such protection was in the public interest[34].

A "public benefits test"under s.56 of the Act could thus set aside entirely the common law doctrine only by imposing a very particular interpretation of the Commerce Act which denies that Part IV (in which section 56 appears) embodies the doctrine of prime necessity. If the argument made above is accepted - that the statutory provisions in Part IV have, for the time being at least, been substituted for the common law but retain the same basic intent – then any public benefit test under Part IV would have to be designed accordingly.

2.6 New Zealand's Politicisation of the Regulatory Process

A final important point regarding the common law and the Commerce Act 1986 is that in the face of monopoly price-gouging of consumers the full onus is on the executive branch of government ("the Minister") to initiate action, since neither the Commerce Commission, the courts, nor the ordinary citizen, have any legal

[34] The *Hansard* debates on the Commerce Bill during 1985 and 1986 contain very little discussion of the issue of natural monopoly, probably because at that time most key monopoly utilities were owned and operated by the state and stated government policy was not to privatise them.

avenue for doing so. This statutory framework has the effect of politicising both the decision to regulate and the level and type of regulation adopted. "The Minister has a broad discretion and can take into account a range of factors." (Commerce Commission 2002, p.17 paragraph 16). The underlying presumption appears to be that the interests of dispersed individual consumers will be better represented and protected through a political than a judicial process. This places a heavy burden on government to resist capture by a small number of very large, well resourced vested interests, and makes it vital that accountability for decisions made under Part IV (including decisions to take no action) is clear and effective.

The case for politicisation seems to have been the neoliberal contention that so-called "distribution issues" are a matter to be dealt with by political judgment, not by any judicial process. Insofar as that was the intent, decisions on monopoly regulation under Part IV would have to incorporate far wider political considerations than simply the three-fold mantra of allocative, productive and dynamic efficiency, and it would be desirable for the Minister's exercise of his or her discretion to be fully politically accountable.

New Zealand's Commerce Act is notable for its failure to establish clear accountability procedures to enable Parliament, and hence the public at large, to hold Ministers to account. There is a striking contrast between the complete lack of any requirement for formal reporting-back to Parliament on the Minister's performance of his or her regulatory duties under the Commerce Act, and the strict accountability procedures imposed on the Minister of Finance under the Fiscal Responsibility Act 1994. The latter statute arguably represents the model with which the Commerce Act should be brought into line. Part of any more rigorous accountability regime established by such amendments could then be an explicit declaration by Parliament that the doctrine of prime necessity is intended to guide ministerial decision-making on the regulation of natural monopoly.[35]

2.7 US Antitrust Law

The main US antitrust statutes are the Sherman Antitrust Act (1890), the Clayton Act (1914) and the Federal Trade Commission Act (1914). The Sherman Act in its original form declared illegal arrangements, contracts, agreements, trusts or combinations that either "prevent full and free competition" or "tend to advance the cost to the consumer"[36]. While the wording of section 1 as finally passed into law did not contain explicit reference to the raising of costs to consumers, it survives in the wording of the US Code Title 15 Chapter 1 section 8, regarding the pricing of imports into the USA: the section prohibits any "combination, conspiracy, trust, agreement, or contract [which] is intended to operate in restraint of lawful trade, or free competition in lawful trade or commerce, <u>or to increase the market price in any part of the United States of any article or articles</u>

[35] Parliament has moved some distance towards this by the 2001 amendment which inserted a new purpose statement as s.1A of the Act, stating that the purpose is to protect the interests of consumers; no one-for-one weighting of consumer and supplier interests is therefore contemplated by the Act or sanctioned by Parliament.

[36] Bork 1996 p.15. See also Sullivan 1991, Martin1994 pp.45-46.

imported or intended to be imported into the United States, or of any manufacture into which such imported article enters or is intended to enter." [Emphasis added.]

Martin (1994) discusses in some detail the congressional intentions behind the Sherman Act, and focuses in particular on the issue of why the raising of prices to consumers was included as a key target for antitrust law. In response to Bork's (1966) argument that Congress must have been thinking only of allocative inefficiency (deadweight loss), Martin puts strongly the case that direct protection of consumers and small business was in fact the main concern of Congress (Martin 1994 pp.46-50[37]):

> The notion of deadweight loss was poorly understood by economists in 1890, and in any event economists had precious little influence on the passage of the Sherman Act… The discussion of high prices could just as well reflect concern with the transfer of income from consumers to producers.
>
> Income transfer is a tangible and obvious effect of monopolistic pricing. Resource misallocation is an intangible and subtle effect. It is clear from the congressional debates that senators knew that monopolistic pricing transferred income from consumers to producers. Speaking in support of the Bill, Senator Sherman said ….. "This bill [seeks] to prevent and control combinations made with a view to prevent competition, or for the restraint of trade, or *to increase the profits of the producer at the cost of the consumer* [emphases added by Martin].
>
> Further: "It is sometimes said of these combinations that they reduce prices to the consumer by better methods of production, but all experience shows that this saving of cost goers to the pockets of the producer…."
>
> These are clear expressions of concern for the distributional effects of market power….
>
> It is unlikely that income distribution was the sole concern of Congress when it passed the Sherman Act. But is seems clear that the redistribution of income from consumers to producers was an effect of market power that Congress hoped to prevent by passing the act. A modern economist would describe consumer welfare – the maximization of consumers' surplus or, equivalently, the minimization of monopoly profit plus deadweight welfare loss - as a likely goal of Congress in passing the Sherman Act.

Martin cites in support of his view a passage in which even Bork (1996) acknowledges that the Act's prohibition of mergers to monopoly "derived in large measure from a desire to protect consumers from monopoly extortion".

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[37] For very similar points see Lande 1982 pp.86-96 on which much of Martin's discussion is evidently based.

Martin's extensive review of the various antitrust statues leads him to conclude that they were underlain by two foundation principles (1994 p.54): "US antitrust laws were intended to advance multiple goals, both economic and noneconomic. When it passed the Sherman, Clayton and FTC Acts, the US Congress was certainly concerned with encouraging and preserving productive efficiency – least cost production – so long as its benefits were passed along to consumers in the form of lower prices. It was equally concerned with minimizing the transfer of income from consumers to producers."

Lande (1982, 1998) has been a strong critic of Bork's interpretation and proponent of the case for regarding the US antitrust laws as primarily directed to the protection of consumers against the taking of unwarranted wealth transfers. In his view (1982 p.70) "Congress implicitly declared that 'consumers' surplus' was the rightful entitlement of consumers; consumers were given the right to purchase competitively-priced goods. Firms with market power were condemned because they acquired this property right without compensation to consumers." Lande then identifies this as a "distributive goal" - terminology which is probably unhelpful, since the basic thrust of Lande's argument is more to do with protection of consumers from predation than with distribution per se. As he points out (1982 p.74 note 37) the antitrust laws were not premised on redistribution from rich to poor, nor with achievement of any "fair" ideal distribution of wealth in society. They were focused on the "fairness of the redistributive process". ("Fairness" here corresponds to the concept of "justice in acquisition" in Nozick.)

Lande argues in addition that the legislative history of the Sherman Act shows that "in balancing the competing considerations, Congress condemned firms with monopoly power despite their acknowledged efficiencies, and with the knowledge that this condemnation might not maximize society's economic efficiency" (1982 p.83). "Congress", Lande suggests (1982 p.90), "wanted to pass a law for other purposes which hampered productive efficiency as little as possible…. [C]ongressional endorsement of trusts' efficient operations stopped when consumer prices rose, and the legislature withheld approval from combinations that, while yielding more efficient methods of competition, also produced higher consumer prices. The trusts were condemned despite their efficiency in large part because they kept the fruits of such efficiency."

Congressional debates on the Sherman Act resounded with terms such as "robbery" and "extortion" applied to monopolistic profit-taking (Lande 1982 p.95). "The legislators decided that competitive prices were 'fair' whereas monopoly prices were not" (1982 p.96). This concern was increased by the perception that the trusts had accumulated social and political, as well as economic, power and that this process threatened democracy itself. "The congressional complaint, therefore, was directed not solely at the effects of monopoly power – higher prices and poorer consumers – but also at the process that produced them" (1982 p.101).

Lande summarises his reading of the legislative history as follows (1982 p.105):

> Congress passed the Sherman Act to further a number of goals. Its main concern was with firms acquiring or possessing enough market power to raise prices artificially and to restrict output. Congress' primary aim was to enable consumers to purchase products at competitive prices. Artificially high prices were condemned not for causing allocative inefficiency but for 'unfairly' transforming consumers' wealth into monopoly profits. All purchasers, whether consumers or businesses, were given the right to purchase competitively priced goods. All sellers were given the right to face rivals selling at competitive prices.
>
> Concurrently, Congress was interested in encouraging efficient behaviour in firms …. Efficiency gains were particularly desired when benefits passed through directly to consumers. A concern with productive efficiency could not, however, explain why Congress passed the Sherman Act.

2.8 The Treaty of Rome

The part of the 1957 Treaty of Rome which addresses monopoly is Article 86 which explicitly describes four categories of "abuse of a dominant position". The first category of abuse, without qualification or hesitation, is "directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions". Article 3(s) includes among the objectives of the European Community "a contribution to the strengthening of consumer protection", and numerous European Commission documents on competition policy refer to the goal of protecting consumers (and other acquirers of goods and services supplied by a dominant firm) against overcharging. What this means is that one aim of competition policy is "protecting the consumer by making goods and services available on the most favourable terms possible"[38].

A recent European Commission review of the scope for introducing an "efficiency defence" for mergers notes that the EU remains committed to the protection of consumers against the taking of monopoly profits (European Commission 2001 p.18):

> Under the EMR, as under US law, merger control takes account only of consumer welfare. Benefits to the merging companies are disregarded. The consumer welfare criterion would be favoured by those who consider that competition authorities should avoid trading off the welfare of one group against that of another. The consumer welfare standard avoids such a trade-off by accepting the efficiency defence only where the nature and size of the efficiency gains are such that, even with reduced competition in the market, the consumer will be no worse off than before the merger

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[38] European Commission, *Sixth Report on Competition Policy 1977,* p.9, cited by Martin (1994) pp.58-59.

3. Canadian Competition Law , *Hillsdown* , *Superior Propane*, and the Use of a Social Welfare Function to Weight Gains and Losses

3.1 The Competition Act 1985 and the 1991 Merger Guidelines

Canada at least until 1985 operated a consumer welfare standard in merger hearings, which in effect took no account of gains to monopoly suppliers when evaluating the public benefits or detriments of mergers (Ross and Winter 2002). The Competition Act 1985 s.1.1 appeared to carry forward a general concern for protecting consumer interests, since it included among the purposes of the Act "to provide consumers with competitive prices and product choices". However, s.96 of the Act allowed an efficiency defence for mergers, in terms which until recently left unsettled the issue of how wealth transfers ought to be evaluated:

> **96.** (1) The Tribunal shall not make an order under section 92 if it finds that the merger or proposed merger in respect of which the application is made has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger and that the gains in efficiency would not likely be attained if the order were made
>
> …
>
> (3) For the purposes of this section, the Tribunal shall not find that a merger or proposed merger has brought about or is likely to bring about gains in efficiency by reason only of a redistribution of income between two or more persons.

Section 96(3) makes clear that the Tribunal is not allowed to consider the possibility that transfers could have, *per se*, any efficiency effects; although the Act provides no definition of efficiency, this would appear to include allocative, productive and dynamic efficiency. Hence the main traditional reasons for restraining monopoly profits, outlined above, were not explicitly set out by the legislature as matters to be taken into account by the Competition Tribunal when considering mergers. This left the Tribunal with the task of deciding how to conduct the weighing-up of possible efficiency gains from a merger against possible detrimental "effects of lessened competition", potentially but not explicitly including wealth transfers[39].

[39] The Federal Court in 2001 has since ruled that as a matter of interpretation, income redistribution is included among the "effects" of a lessening of competition in s.96(1): "If Parliament had intended redistribution of income to be *excluded altogether* from the 'effects' of an anti-competitive merger, as the Tribunal held [in *Canada (Commissioner of Competition) v. Superior* Propane 2000 Comp. Trib. 16] the drafter might well have been expected to have made an express provision, similar to that contained in subsection 96(3) with respect to the efficiencies side of the balance. The absence of such a provision suggests that … Parliament did not intend to impose such a limitation on the 'effects' side" (in *Canada (Commissioner of Competition) v. Superior* Propane 2003 FCA 53 at 83.

This inescapably raised the issue of how losses to consumers were to be compared with gains to suppliers. The pure consumer welfare standard gives zero weight to producer gains. The total surplus standard in its usual form as propounded by Bork (1978) treats gains in producer surplus as offsetting losses to consumer surplus on a dollar-for-dollar basis. Between these two lies what the Canadian courts refer to as the "balancing weights standard"[40] which assigns explicit weights to the sums received or surrendered by the various parties to a wealth transfer.

In 1991 the Competition Bureau issued its *Merger Enforcement Guidelines*[41] in which the words "anticompetitive effects" were interpreted as being limited narrowly to allocative inefficiency: "anticompetitive effects refer to the part of the total loss incurred by buyers and sellers in Canada that is not merely a transfer from one party to another, but represents a loss to the economy as a whole, attributable to the diversion of resources to lower valued uses. This loss is sometimes referred to as the deadweight loss to the Canadian economy." (*Merger Enforcement Guidelines* section 5.1). "Where a merger results in a price increase, it brings about both a neutral redistribution effect and a negative resource allocation effect on the sum of producer and consumer surplus (total surplus) within Canada. The efficiency gains described above are balanced against the latter effect, i.e., the deadweight loss to the Canadian economy" (*Guidelines* section 5.5).

This approach implied adoption in its totality of the total surplus standard as set out by Bork (1978) and Posner (1981 Chapter 4). "When a dollar is transferred from a buyer to a seller, it cannot be determined a priori who is more deserving, or in whose hands it has a greater value" (*Guidelines* part 5 footnote 57).

It needs to be borne in mind when reading these passages in the *Guidelines* that the issue was merger approval, not regulation of established natural monopolies. It is, however, difficult to see how principles applying to the evaluation of wealth transfers in merger cases could be prevented from flowing through, as a matter of logic, to the evaluation of identical wealth transfers in the context of monopoly[42]. There was extensive discussion during the *Propane* case over the correct interpretation of the relationship between s.92 and s.96 of the Competition Act. One dissenting Tribunal member in the initial hearing[43], the Competition Commissioner in argument before the Federal Court[44], and one of the three judges in the 2003 decision of the Court[45] considered that as a matter of principle

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40 E.g. *Canada (Commissioner of Competition) v. Superior Propane Ltd*, 2003 FCA 53 at 32.

41 At http://cb-bc.gc.ca/epic/internet/incb-bc.nsf/vwGeneratedInterE/ct01026e.html.

42 The Competition Commissioner endeavoured to argue for such a qualitative change between 98% and 100% market share before the Competition Tribunal in 1999; in *Canada (Commissioner of Competition) v. Superior* Propane 2000 Comp. Trib. 16 at 416-417. The argument was rejected (ibid. at 418).

43 Dissenting opinion of Christine Lloyd in *Canada (Commissioner of Competition) v. Superior* Propane 2000 Comp. Trib. 15 at 506-508 and 511-512.

44 Cf *Canada (Commissioner of Competition) v. Superior Propane* Competition Tribunal "Reasons and Order" 4 April 2002 at 259-260; 2003 FCA 53 at 46 – 52.

45 LeTourneau JA partial dissent in in *Canada (Commissioner of Competition) v. Superior* Propane 2003 FCA 53 at 78: "the issue of monopolies in the context of an Act which

monopoly ought to be treated as a special analytical category. Had the authors of the 1991 *Guidelines* been forced to address the monopoly implication of their approach, it might have given them pause, bearing in mind the Competition Act's explicit purpose of protecting consumers from prices above the "competitive" level.

3.2 Hillsdown

At the time the Merger Guidelines were published, the Canadian Competition Tribunal had before it an application to reverse the merger of two Ontario meat rendering companies, Hillsdown Holdings (Canada) Ltd and Ontario Rendering Company Ltd. The Tribunal turned down the application, for reasons unrelated to the efficiency defence (the lessening of competition was considered, as a "borderline"matter, to be insufficient to justify divestiture in the light of ongoing trends in the market[46]; and divestiture was considered an ineffective remedy[47]).

As part of its case, the respondent presented an efficiency defence for the merger, on the basis of claimed cost savings totaling $2.2 million per year. The Tribunal found that the onus of proof lay with the respondent (Hillsdown) and had not been satisfied. Although the case did not turn on this issue, the presiding judge of the Tribunal, Justice Barbara J. Reed, took the opportunity to lay out strong criticisms of the *Merger Guidelines*, paving the way for the 2001 decision of the Federal Court in *Propane* (see below). She stated that "the respondents based their trade-off analysis on a legal interpretation of section 96 which the Tribunal does not think is correct"[48], and went on to a legal interpretation of s.96(1)[49]:

> In order to understand the arguments which were presented to the Tribunal respecting the proper interpretation of section 96, it is necessary to refer to a distinction which is made by economists between two different types of detrimental effects which may result from a firm having a monopoly or dominant position in a market. If the merger results in the merged entity being able to raise prices above what would exist in a competitive market, then a transfer of funds (the wealth transfer) from the consumer to the producers is likely to occur. While this will be detrimental to individual consumers personally, it is not necessarily classified by economists as detrimental to society as a whole. This thesis postulates that there is no reason to suppose that

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favours competition is not a mere question of evidence. It is a question of principle, a fundamental issue which has been addressed by Parliament in section 1.1 of the Act….. [I]t is the ultimate adverse, anti-competitive effect, an effect that runs counter to the expressed values, purposes and objectives of the Act."

46 *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd* (1992) 41 C.P.R. (3d) 289 (Comp. Trib.), CT-91/1, p.75

47 *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd* (1992) 41 C.P.R. (3d) 289 (Comp. Trib.), CT-91/1, p.100.

48 *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd* (1992) 41 C.P.R. (3d) 289 (Comp. Trib.), CT-91/1, p.84. The sole authorship of this part of the decision by Reed J is identified in footnote 79 p.86.

49 *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd* (1992) 41 C.P.R. (3d) 289 (Comp. Trib.), CT-91/1, section VI.B, pp.84-97.

> the wealth transfer in the hands of the purchaser (consumer) would be used for any more socially beneficial purpose than would be the case if it were in the hands of the producer (seller). What is important under this economic value judgment is the detrimental effects which arise from a merger which lead to losses for society as a whole.
>
> Detriment to society as a whole is said to arise, for example, when consumers because of the higher prices choose an alternative and less appropriate substitute product for the use they have in mind. They substitute a product which would have been their second choice in a competitive market. This inefficient substitution is seen as a misallocation of resources; it is seen as a loss to society as a whole….
>
> Both the Director and the respondents argue that subsection 96(1) directs the Tribunal to balance "the gains in efficiency" which will arise from the merger against this allocative inefficiency or deadweight loss…. [Here followed an extract from the *Merger Guidelines* declaring the redistributive effects to be neutral]
>
> The Tribunal has difficulty accepting this interpretation. … If only allocative inefficiency or the deadweight loss to the Canadian economy was intended by Parliament to be weighed in the balance then one would have thought that the section would have been drafted to specifically so provide. The interpretation which both the Director and the respondents put on section 96 requires a reading down of the phrase "effects of substantial lessening of" so that it does not include the transfers from consumers to producers which will generally be the largest effects of the substantial lessening.

Reed J then referred to Whish (1985) to show that the established purposes of competition law include protection of the consumer from being charged supra-competitive prices, encouraging the dispersal of power and the distribution of wealth, and protection of small firms against more powerful rivals, in addition to the promotion of economic efficiency. She noted that the Competition Act s.1.1 contains multiple objectives which seem to include (and certainly do not explicitly exclude) these matters. The issue for the Tribunal was whether the efficiency objective ought to have precedence in the case of a conflict amongst the objectives. Reed J considered that "there is nothing in the text of the purpose section which indicates that such preference is to be given"[50], even though efficiency was the first objective listed. Nor were the parliamentary debates over the Competition Act of assistance.

She then quoted extensively from the American Bar Association's (1986) summary of the vigorous US debate over the efficiency defence and concluded that a balance among the objectives of the Act should be struck on the basis of the evidence in particular cases, and should not be predetermined by a total-surplus-standard reading of sections 1.1 and 96(1). In this context she questioned (but did

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[50] *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd* (1992) 41 C.P.R. (3d) 289 (Comp. Trib.), CT-91/1, p.91.

not explore in any detail) whether the judgment that wealth transfers were neutral in their social impact could be sustained across all possible factual situations, and clearly hinted that the answer should be no. The two examples she mentioned were a life-saving drug (where the implied proposition appeared to be that allowing monopoly rents to the producer of the drug served a positive social purpose) and foreign-owned monopolies (whose rents were transferred out of Canada so that there was a social detriment to the national community).

Hillsdown did not lead to any change in the *Merger Guidelines*, and the issues raised by Reed J were not tested before a court until 2000 when the *Superior Propane* case came before the Federal Court.

3.3 Superior Propane

The debate over the total surplus standard was central to *Propane*, which seems to be the first major merger action anywhere in the world to date in which the efficiency defence has succeeded[51]. The facts in *Propane* are straightforward. In 1998 Superior Propane Inc, with roughly a 40% nationwide market share, acquired ICG Propane Inc, with 30% market share. The merged entity would have a dominant position in the "national accounts market" (contracting, coordinating and invoicing supply to customers operating nationwide) and also a dominant position in most geographic markets for the retail supply of propane within Canada. The merger was estimated to result in productive efficiency gains of $29.2 million per year[52], deadweight losses of at most $6 million per year[53], and a transfer from consumers to the merged entity of $40.5 million per year[54].

On these figures, the efficiency defence of the merger clearly succeeded if the total surplus standard was applied but would have failed under the consumer welfare standard. Under a balanced weights approach the decision could go either way depending on the weights. The Competition Commissioner applied to the Competition Tribunal to have the merger rejected, but was turned down on the basis of the total surplus standard. The Federal Court overturned this on appeal, and required the Tribunal to reconsider, using a balanced weights standard but leaving to the Tribunal's judgment to decide which weights were appropriate.

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51 In the USA a more guarded efficiency defence, which left untouched the adherence by both the courts and the FTC to the consumer welfare standard, was introduced by the Clinton Administration's April 1997 amendments to section 4 of the Federal Trade Commission's *Horizontal Merger Guidelines* (http://www.ftc.gov/bc/docs/horizmer.htm)(see Balto, D., "The Efficiency Defense in Merger Review: Progress or Stagnation?", *Antitrust*, Fall 2001, pp.74-81). Cases since 1997 in which the defence has been unsuccessfully invoked are *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997); *FTC v. Cardinal Health, Inc*., 12 F. Supp.2d 34 (D.D.C. 1998); and *FTC v. Heinz*, 116 F. Supp.2d 190 (D.D.C. 2000), *rev'd*, 246 F.3d 708 (D.C. Cir. 2001). In none of these were the claimed efficiencies accepted on the evidence.

52 *Canada (Commissioner of Competition) v. Superior Propane* Competition Tribunal "Reasons and Order" 4 April 2002 at 371.

53 *Canada (Commissioner of Competition) v. Superior Propane* Competition Tribunal "Reasons and Order" 4 April 2002 at 231 and 371; the Tribunal placed an upper bound estimate of $6 million on possible deadweight loss.

54 *Canada (Commissioner of Competition) v. Superior Propane* Competition Tribunal "Reasons and Order" 4 April 2002 at 366.

The Tribunal in 2002 produced a new decision which again approved the merger, applying weights which allowed only $2.6 million of net social detriments from the $40.5 million of wealth transfers[55]. The Commissioner appealed the decision on the basis that the Tribunal had paid mere lip service to the Court's instructions while showing, in its extensive criticisms of the Court's 2001 reasoning, a bias against genuinely reconsidering its view in favour of the merger. In January 2003 the Court, while giving the Tribunal a stiff reprimand for questioning the interpretation of the law by the superior court[56], accepted that it was for the Tribunal to exercise its own judgment on the appropriate weights to be used in a balancing text, and upheld the Tribunal decision.

The *Propane* decision represents in principle a defeat for advocates of Bork and Posner's strong version of the total surplus standard, and a victory for those economic theorists who regard a social welfare function, with explicit weights assigned to various social groups, as the appropriate way to evaluate net public benefits. From the point of view of the present paper, unfortunately, none of the judgments in the case came fully to grips with the classification of wealth transfers in terms of basic principles of limited property rights embodied in the old common law.

This accounts for two important limitations on the *Propane* decisions. First, because neither the Competition Act, nor the *Merger Guidelines*, nor the Commissioner in his arguments before the Tribunal and the Court, sought to establish that there was anything wrong *per se* with the taking of monopoly rents, it was not possible to sustain the consumer welfare standard on a logically consistent basis. The closest the Commissioner might have come to doing so would have been to argue for weights of 100% for consumers and zero for producers in the "balancing weights standard", but all parties seem to have accepted either tacitly or explicitly that this would have violated the spirit of the balancing procedure as advanced by the Commissioner's expert witness, Professor Townley, who was the sole source of evidence on this matter. The Commissioner's general arguments for the consumer welfare standard were consequently unsuccessful.

Nor did the dissenting opinions in either the Tribunal (Christine Lloyd) or the Federal Court (LeTourneau J) succeed in spelling out clearly the principled basis on which monopoly could be held to be a "qualitative" detriment, although they read into an Act ostensibly devoted to the promotion of competition.

Second, the grounds on which gains and losses to various parties to a wealth transfer ought to be weighted for evaluation were restricted by the Tribunal to considerations of social deserving-ness. Justice Reed's *obiter dictum* in *Hillsdown*[57] had raised the question whether wealth transfers should be presumed neutral, and clearly signaled that in her view the answer was no, but had provided no fullaccount of the issues she had in mind – only the two examples of a life-

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55 *Canada (Commissioner of Competition) v. Superior Propane* Competition Tribunal "Reasons and Order" 4 April 2002 at 368.

56 *Canada (Commissioner of Competition) v. Superior Propane* 2003 FCA 53 at 53-54.

57 *Canada (Director of Investigation and Research) v. Hillsdown Holdings (Canada) Ltd* (1992) 41 C.P.R. (3d) 289 (Comp. Trib.) section VI.B.

saving drug and a foreign owned firm. (Even these two examples make clear that what she had in mind was not social deserving-ness, however, but rather issues of dynamic efficiency and nationality.) When the Federal Court came to the issue in 2001 its grounds for referring the case back to the Tribunal had nothing to do with economic theory – what the Court held was merely that the Tribunal had exceeded its jurisdiction in seeking to lay down general principles of law in its interpretation of s.96. The Tribunal was accordingly directed to reconsider the *Propane* case on its particular merits, and its attempt to establish the total surplus standard as a general legal precedent was rejected. The Federal Court provided, however, no directions to the Tribunal regarding the criteria it was to use in weighting transfers for the purpose of evaluating the effects of lessened competition.

The Tribunal thereupon, as it was fully entitled to do, exercised its judgment to determine that only a single group was deserving of special weight: low-income households using propane for essential purposes, for whom the adverse transfer from the anticipated 11% price increase was \$2.6 million.[58] Only by placing very high weights on this detrimental transfer could the Tribunal's previous decision be overturned. Accordingly the Tribunal settled for the conclusion that "under any reasonable weighting scheme, the gains in efficiency of \$29.2 million are greater than and offset all of the effects of lessening and prevention of competition attributable to the merger."[59] In reaching this conclusion it rejected the (opinion) evidence on appropriate weightings from Professor Townley, the sole witness heard on this aspect of the case, whose application of the balancing weights standard had pointed to rejection of the merger.

3.4 After Propane

After *Propane*, uncertainty reigns as to how future contested merger cases will be decided in Canada. The intellectual gulf separating the majority on the Tribunal from the Competition Commissioner and the Federal Court is wide, and the tone of successive decisions became increasingly intemperate as strongly-held prior views on the efficiency defence were challenged. Advocates of Williamson-Bork-Posner suffered an eleventh-hour technical defeat on the wealth transfer issue, but carried the day on successful efficiency-based defence of the Propane-ICG merger. Supporters of the consumer welfare standard can take no comfort from the Federal Court's rejection of the pure total surplus standard, since virtually any merger case can now be swung to a desired result simply by the exercise of discretionary judgment by the Tribunal. Hence the membership of the Tribunal (comprised of individuals who are likely to hold prior views for or against the various possible standards) will dictate the nature of the judgment brought to bear on transfers, and hence the outcome.

Basic issues of principle therefore remain unresolved in Canada, and the lessons New Zealand tribunals ought to draw from the recent Canadian debate are

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[58] *Canada (Commissioner of Competition) v. Superior Propane* Competition Tribunal "Reasons and Order" 4 April 2002 at 367-368.

[59] *Canada (Commissioner of Competition) v. Superior Propane* Competition Tribunal "Reasons and Order" 4 April 2002 at 368.

correspondingly limited. One general conclusion is, however, that a total surplus standard ought not to be adopted by a tribunal such as the Commerce Commission without explicit direction to that effect from the legislature; a total surplus standard ought not to be read into ambiguous wording of an existing statute by tribunals as a matter of general interpretation. Insofar as New Zealand's Commerce Act 1986 is as ambiguous as Canada's Competition Act, the Propane precedent would block the Commerce Commission from interpreting the law as requiring use by it of the total surplus standard.

A second lesson is that where a competition law makes explicit reference to consumer welfare in its purposes (as does New Zealand's amended Commerce Act s.1A), the *Propane* precedent indicates that allocative and productive efficiency do not have absolute precedence over other objectives.

4. The Impasse in Theoretical Welfare Economics

4.1 The Standard Textbook Treatment of Monopoly Profit

To discover what attitudes towards, and beliefs about, any major policy issue are prevalent in the professional community of economists, it is informative to review the textbooks used at introductory and intermediate levels of economics teaching at universities.

Such a review of a number of leading texts shows that the key propositions underpinning the 1991 Canadian Merger Guidelines, the 1994/97 New Zealand merger guidelines, and the 2003 *Framework Paper* analysis of natural-monopoly profits, correspond to views which are widely held by academic economists and taught to today's generation of students. This reflects the success with which advocates of the Williamson/Bork/Posner position on wealth transfers have promoted their views within the profession, and leads naturally to the question whether the prevailing view is in fact well grounded in established theory.

To anticipate what is to come, it will turn out that the key step in the logic of the total surplus standard – the proposition that a dollar is a dollar – has no non-arbitrary basis in economic theory[60]. Whether transfers are neutral from the standpoint of social welfare is indeterminate in terms of the standard neoclassical microeconomic paradigm. Economists working within that paradigm therefore have no theoretically coherent grounds, <u>as economists</u>, for rejecting the consumer welfare standard. It has already been noted that other economists more directly concerned with the performance of the aggregate economy –

[60] As Slesnick (1998) points out, "the common practice of representing social welfare by per capita income implicitly assumes cardinally measurable welfare that is fully comparable across housegholds …. [T]he implicit social welfare function is utilitarian and the marginal utility of income is assumed to be constant" (p.2109). Elsewhere he repeats (1998 p.2141) "Simply summing the surplus measure, as is common, embodies a version of utilitarianism … This and other approaches to aggregation requires assumptions concerning distributiove ethics and there is no way round this issue. The differences on the various approaches lies in whether the assumptions are implicit or explicit"

macroeconomists, economic historians, and growth economists – generally regard monopoly predation as a social bad because of its corrosive effect on incentives to save and invest. An alternative school, the Schumpeterians, argue for positive growth effects from monopoly rents, but have had difficulty mustering econometric (as distinct from anecdotal) support for their hypothesis[61].

The textbook writers are in broad agreement over how monopoly rent transfers ought to be viewed from the point of view of social welfare analysis. The majority position is that neoclassical microeconomics provides no *a priori* basis for regarding any transfer of wealth of income as good or bad, so that no objective basis exists for assigning, say, greater weight to consumer losses than to monopolists' gains. In the words of Viscusi et al (2001 p.81) "the standard view of economists is that assigning an equity cost… is arbitrary. Economic analysts currently have no empirical basis for assigning any specific value to … equity costs. Nevertheless, it is certainly true that the political process gives great weight to equity issues."

Taylor and Frost take a more definite position (2002 p.236) "the monopolist takes, in the form of profits, some of the consumer surplus that would have gone to the consumers in competitive markets. … However, this transfer of consumer surplus to the monopoly is not a deadweight loss, because the monopoly gains what the consumers lose. The transfer affects the distribution of income, but it is not a net loss to society" [emphasis added]. That the transfer is not a deadweight loss is commonly agreed – but that it is "not a net loss to society" is emphatically not a warranted conclusion to draw, unless the authors are privy to society's welfare function and that welfare function positively declares society to be indifferent among all its members with respect to gains and losses. Absent such a social welfare function, Taylor and Frost would seem to have imported some unstated set of ethical preferences from outside the standard neoclassical model. They are not alone in this, however.

Mankiw (2002 pp.328-329), for example, is only slightly more circumspect, but does at least admit that where "economics" has no clear basis for weighting the welfares of different groups, it would be reasonable to look elsewhere for guiding principles:

> It is tempting to decry monopolies for 'profiteering' at the expense of the public. And, indeed, a monopoly firm does earn a higher profit by virtue of its market power. According to the economic analysis of monopoly, however, the firm's profit is not in itself necessarily a problem for society.
>
> Welfare in a monopolized market, like all markets, includes the welfare of both consumers and producers. Whenever a consumer pays an extra dollar to a producer because of a monopoly price, the consumer is worse off by a dollar, and the producer is better off by the same amount. This transfer from the consumers of the good to the owners of the monopoly does not affect the market's total surplus - the sum of consumer and

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[61] See, for discussion of this point, Parente and Prescott 1999.

> producer surplus. In other words, the monopoly profit itself does not represent a shrinkage in the size of the economic pie; it merely represents a bigger slice for producers and a smaller slice for consumers. Unless consumers are for some reason more deserving than producers – a judgment that goes beyond the realm of economic efficiency [emphasis added] – the monopoly profit is not a social problem."

Salvatore (2003 p.326) agrees: "… monopoly profits are not a net loss to society as a whole, because they represent simply a redistribution of income from consumers of the commodity to the monopolist producer. This redistribution is 'bad' only to the extent that society 'values' the welfare of consumers more than that of the monopolist. …[A]ll of the monopolist's profits could be taxed away and redistributed to consumers of the commodity."

Nicholson (2002 p.504) notes that monopoly profits "reflect a transfer of income from consumers to the firm. Whether such a transfer is regarded as desirable depends on prevailing societal norms about whether consumers or the monopoly are more deserving of such gains. As for any transfer, difficult issues of equity arise in attempting to assess social desirability. There is no ambiguity about the loss in consumers surplus [in the deadweight loss triangle] however, because this loss is not transferred to anyone. It is a pure 'deadweight' loss…."

Begg, Fischer and Dornbusch (1987 p.361) agree that the distributional issue turns on normative (subjective) judgment. Having constructed the usual diagram to show pure monopoly profit, they ask

> "Should society tolerate such privately collected taxes? Whether we think the high price… charged by a monopolist is a rip-off or the just reflection of what consumers are prepared to pay is a pure value judgment about equity. …. [I]n addition to any efficiency argument against monopoly, society may decide that it dislikes monopoly profits purely on the grounds of equity. Suppose the government imposes a profits tax on a monopolist: what effect would this have on the monopolist's output decision? The simple answer is that it would have no effect! Why not? Because, whatever the tax rate (assuming it is less than 100%), the way to maximize after-tax profits is to maximize pre-tax profits…. Hence the monopolist will produce exactly the same output as in the absence of a profits tax and, facing the same demand curve, will charge the same price as before. Since it is always open to the government to tax away a monopolist's excess profits, it is the allocative inefficiency of monopoly on which economists have focused their criticisms."

Sloman and Norris (2002 p.171) concede that "[t]he high profits of monopolists may be considered unfair, especially by competitive firms, or anyone on low incomes for that matter", and with particular reference to natural monopolies they point out (p.303) that under public ownership it will be possible to secure the economies of scale that justify monopoly provision, yet set prices that just cover actual costs and no more, so that only normal profits are earned. They stop short, however, of actually recommending this course of action.

The theme that efficiency analysis can lead to unambiguous "objective" statements about welfare, whereas distributional issues involves subjective value judgments and are the business of a separate "branch of government" (to paraphrase Mulgrave 1959 and Friedman 1962), is echoed even by authors more sympathetic to consumer interests. For example Frank and Bernanke (2004 p.243) comment that "[m]onopoly is problematic not only because of the loss in efficiency associated with restricted output but also because the monopolist earns an economic profit at the buyer's expense. Many people are understandably uncomfortable about having to purchase from the sole provider of any good or service. For this reason, voters in many countries have empowered government to adopt policies aimed at controlling natural monopolists."

Colander (2004) p.277 states that while efficiency losses are the primary problem with monopoly, there are also "normative" views against monopoly, one of which is that "the public doesn't like the income distributional effects of monopoly… This distributional effect of monopoly … is another reason many laypeople oppose monopoly: They believe it transfers income from 'deserving' consumers to 'undeserving' monopolists".

Stiglitz and Walsh (2002 p.245) note that pure monopoly profits "are not required to elicit greater effort or production on the part of the monopolist" and hence are rents. Discussing the regulation of natural monopolies in countries such as the USA they note (p.275) that "the aim of regulation is to keep the price as low as possible, commensurate with the monopolist's need to obtain an adequate return on its investment. In other words, they [regulators] try to keep price equal to average variable costs".

Samuelson and Nordhaus (1998 p.308), discussing public utility regulation, do at least reverse the burden of proof: "… the owners of the monopoly are presumably no more deserving than the consumers. So there is no reason to allow them to extract monopoly profits from consumers."

The majority of the textbooks reviewed above move unashamedly from the principle that there is no clear "economic" case against monopolistically-enforced wealth transfers, to a conventional discussion of the practice of public utility regulation in the USA and UK, and analysis of the most efficient means of achieving such regulation, whose objectives (elimination of supernormal profits, and achievement of incentives for economic efficiency) are taken as given. The basis for utility regulation in these texts is treated as political, "non-economic", and subjective: generally it seems to be regarded as resting on the notion that consumers "deserve" protection against the taking of monopoly profit. None of the textbooks raises any principled objection to this allegedly political proposition, but neither does any of them provide a principled defence for it. The issue is considered to lie legitimately with the political authorities, and the "economists" represented by this literature evidently regard whatever policy decision is made as ultimately an arbitrary matter from the standpoint of economic theory.

To summarise the mainstream consensus position in microeconomics, as reflected in the current crop of textbooks, neoclassical micro-economics is

believed by its expositors to be unable to offer any unambiguous "objective" basis for saying whether society is made better off or worse off by the taking of monopoly profits from consumers.

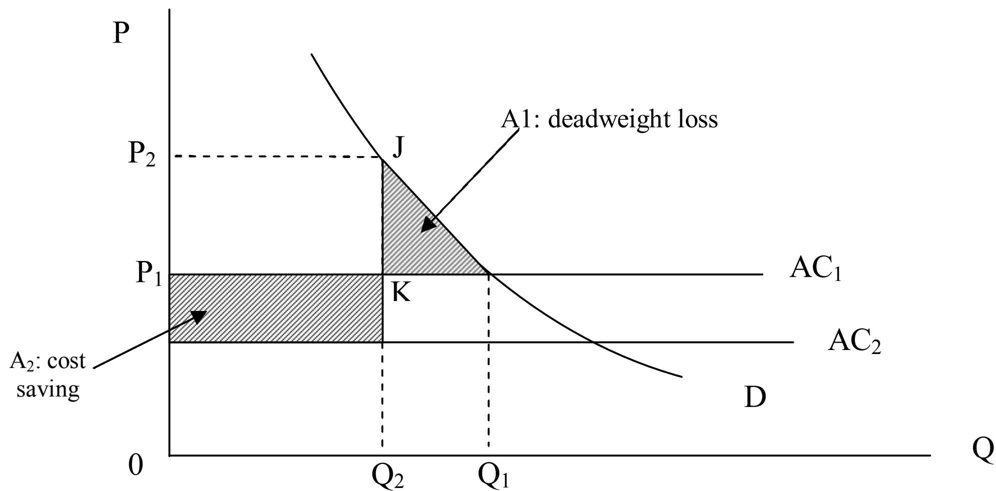
There are, of course, very eminent economists to be found who have ventured to give greater weight to consumer detriments than to monopoly benefits in cost-benefit analyses of monopoly pricing, notwithstanding the problem of "arbitrariness". A good example is Arrow and Kalt's (1979) analysis of the social costs and benefits of removing oil price controls in the USA, in which the authors assumed that each dollar transferred from consumers to producers as a result of decontrol of prices caused a social loss of 50 cents. This application of what Canadians now call the "balancing weights standard" is criticised by Viscusi et al (2001 p.81) on the basis that "the standard view of economists is that assigning an equity cost of this sort is arbitrary". What Viscusi et al neglect to go on to say is that the equal weighting of consumer and producer welfare (the total surplus standard) which they evidently favour for their own analysis is no less arbitrary. The mainstream position simply does not resolve the issue of how to weigh up benefits and losses accruing to different individuals.

Certainly one cannot simultaneously insist upon the arbitrariness of any weighting scheme applied to income and wealth distribution, and then claim anything other than pure arbitrariness for the practical rule of thumb that "a dollar is a dollar" – that is, that all groups' welfare is to be weighted equally. This rule of thumb is vulnerable to two familiar criticisms: that (as already noted) it is no less arbitrary than any other weighting scheme, and that if economists are unable themselves to offer any conclusive criterion for comparing gains and losses for different groups, their appropriate course of action is to respect whatever weighting scheme emerges from the political process. "Efficiency" would then be not an end in itself, but simply a matter of finding the most effective means to socially-defined ends. These lines of argument are considered further below, beginning with the 1968 and 1977 Williamson papers from which so much recent policy and textbook writing has flowed.

4.2 Williamson, Harberger, Bork and Posner

In his influential 1968 paper Williamson proposed that an efficiency defence for otherwise anti-competitive mergers should be allowed by a court or tribunal considering whether to authorize such mergers. He drew (1968 p.21 Figure 1) a diagram showing the welfare impacts of a merger which had two results: (i) an increase in market power which Williamson assumed to flow through, without regulatory intervention, to an increase in price and hence a fall in quantity; and (ii) a fall in average cost resulting from the productive efficiencies made possible by the merger. The model is reproduced as Figure 2.

Figure 2: Williamson's "Naïve Model"



Williamson's point was that a merger which cut costs from AC_1 to AC_2, while at the same time increasing market power and so driving up the price from P_1 to P_2, presents the policymaker with a tradeoff between two efficiency magnitudes. Production-cost savings (the area A_2) are a clear gain from society's point of view, while allocative deadweight losses (the area A_1) are a loss to society. The net balance of these two gives the net gain or loss in productive and allocative efficiency; where there is a net gain, this should, Williamson argued, be regarded as a *prima facie* factor in favour of the merger.

An unqualified proposition that this net balance of allocative effects should alone be determinative of the outcome is not found in Williamson's 1968 paper, however. He is clear that his case for consideration of an efficiencies defence "does not of course mean that the mere existence of economies is sufficient to justify a merger" (p.34). His case is simply that where net economies can be argued to arise, this should "give the antitrust authorities pause before disallowing … a merger" (p.34), and that allocative efficiency ought to be part of antitrust hearings. In his 1977 revisiting of the issue Williamson again explicitly rejected adoption of "a full-blown efficiencies defense" (1977 p.734), emphasizing that his intention was simply to advocate the explicit inclusion of efficiency tradeoffs in merger analysis and to set out "a framework within which sociopolitical and other economic objectives thought to be relevant to merger policy can be examined in relation to an allocative efficiency goal" [emphasis added].

The model set out above is characterized by Williamson as "naïve", and the reasons for so labeling it are set out in some detail in the main body of the 1968 paper. Of the various assumptions and qualifications he discusses, two are of particular relevance here.

First, Williamson's partial-equilibrium approach explicitly makes the assumption that "social and private costs are … identical (externalities … are… assumed to be zero)" (1968 p.22 footnote 4). The resulting qualifications which he acknowledges are potentially wide-ranging in their implications:

- "By isolating one sector from the rest of the economy [the partial-equilibrium analysis on which the 1968 paper rests] fails to examine interactions between sectors. Certain economic effects may therefore go undetected, and occasionally behaviour which appears to yield net economic benefits in a partial equilibrium analysis will result in net losses when investigated in a general equilibrium context" (p.23).
- "It is…vital to consider not merely the market power effects of any single merger taken in isolation, but whether the merger is representative of a trend. If a series of such mergers can reasonably be expected, the judgment of whether to permit any given combination should properly be cast in an industry context – in which case the anticipated economy and market power effects throughout the industry should be examined." (p.26).
- "The political implications of the control over wealth involve a judgment of how the quality of life in a democracy is affected by size disparities. The latter is less easily (or even appropriately) expressed in efficiency terms. The issue is nevertheless important" (p.29).

Second, Williamson deals in some detail with the issue of how transfers between consumers and producers should be evaluated. "On the resource allocation criteria for judging welfare effects … the distribution of these profits becomes a matter of indifference. For specific welfare valuations, however, we might not always wish to regard consumer and producer interests symmetrically – although since, arguably, antitrust is an activity better suited to promote allocative efficiency than income distribution objectives (the latter falling more clearly within the province of taxation, expenditure and transfer payment activities), such income distribution adjustments might routinely be suppressed. If they are not, the tradeoff between efficiency gains and distributive losses needs explicitly to be expressed. Thus, while economies would remain a defense, any undesirable income distribution effects associated with market power would be counted against the merger rather than enter neutrally as the naïve model implies" (pp.27-28). [Emphasis added.]

The point is reiterated in Williamson's 1977 paper (1977 p.711): "a product-specific claim that user and producer interests should be weighted unequally as they relate to the region P_2JKP_1 [in Figure 2 above] does not vitiate the partial equilibrium model. It merely requires that the appropriate weights be specified. To the extent that purchaser interests are given greater weight than supplier interests, the economies burden is increased, *ceteris paribus*."

The above qualifications potentially go to the heart of the issue as sketched earlier in this paper. Stripping away Williamson's "qualifications" converts his model into a simple total-surplus-standard, but exploring them directly opens the way to either a consumer welfare standard or a balancing-weights standard. Such exploration does not involve any necessary switch from "objective" to "subjective" reasoning, nor from economic to non-economic analysis, nor from the realm of efficiency to the realm of "fairness". Nor do economists need immediately to declare their discipline at a loss to illuminate the issues surrounding transfers. It is, however, correct to say that on this territory economics finds itself in precisely the same position as other disciplines,

including politics and law, namely that to reach real-world policy conclusions there is no escape from the need to apply some ethically-based standard to the measurement of social welfare, whether this is regarded as an aggregate of individual welfares, or as a holistic entity other than the sum of society's individual parts.

The contemporary textbook consensus on measurement of social welfare is based upon Harberger's proposal that (1971 p.785) "when evaluating the net benefits or costs of a given action … 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." This approach, often captured by the slogan "a dollar is a dollar", implicitly assumes (i) that the social welfare function is utilitarian, in the sense that interpersonal comparisons are possible and each individual's dollar is worth the same as each other individual's dollar; and (ii) that the marginal utility of income is constant so that all dollars are worth the same to each individual. The sole legitimate argument for this procedure is that it is operationally convenient, given that the relevant magnitudes are measured in dollar terms. This has force only if there is good reason to believe society to be genuinely indifferent between winners and losers in terms of "deservingness" or "entitlements". Otherwise "a dollar is a dollar" is no more than a slogan to conceal the exercise of arbitrary judgment by the economic analyst – precisely the mistake against which the "new welfare economics" should have provided intellectual immunity. The issues have recently been reviewed, and the arbitrariness of one-for-one weighting re-emphasized, by Slesnick (1998).

The unqualified adoption and promotion of Harberger's version of the total surplus standard is a central feature of Bork's 1978 book *The Antitrust Paradox* which appears to have had quite undue influence on competition law practitioners, and to which I shall return shortly.

If neoclassical welfare micro-economists are in fact professionally agnostic about welfare weights, then so long as the raging debate over how to aggregate social welfare remains unresolved, we are left with two areas where the economics profession ought to be able to find common ground. First, if the legislature decides to redistribute wealth from any one group to any other, welfare economics (having so ostentatiously abdicated from any ability to make distributional value-judgments) has no sound basis for criticising that decision. Second, decisionmakers ought to be able to rely on economists for technical support in their pursuit of politically-defined ends: specifically, the application of analysis of empirical evidence, sound commonsense, and working through the implications of underlying theories of the nature of property rights and the state, and hence the purpose and legitimacy of institutional remedies to rescue humankind from "the inconveniencies of the state of nature" (Locke, paraphrased by Nozick).

With this in mind, it is time to turn to Posner. For present purposes his 1981 book, *The Economics of Justice*, will suffice. There are two essential steps in Posner's reasoning regarding monopoly rent. First, in Chapter 5 he offers an ideal model of the minimalist or "nightwatchman" state which "has only one function – to assure physical; security in both its internal and external aspects"

(1981 p.120). This recognizably resembles the Nozick conception discussed earlier, which implies that the "internal" function of the nighwatchman state must extend to restraint on monopoly[62]. Posner's catalogue of the "internal" functions of the state is therefore worth quoting (1981 p.121):

> Without some minimal public order, community welfare would be diminished. This is not to say that without a state people would run amok, killing and stealing from each other. They would take measures to protect themselves from coercion, whether by going around armed, maintaining a retaliatory capacity, living in extended family groups, concealing their possessions, or switching to activities (such as hunting compared to agriculture) that require less of the kind of investment that can be readily appropriated by someone else. But these are costly measures, and it is generally believed – on the whole correctly…. – that basic protection can be provided more efficiently publicly than privately. [Emphasis added].

It has already been seen that a central plank of the traditional case against abuse of monopoly power is precisely the proposition that allowing monopoly profits to be taken as unrequited transfers, from those without market power of their own, has the effect of discouraging "the kind of investments that can readily be appropriated by someone else", and that such diversion resulting from unchecked predation diminishes community welfare. The notion that monopolistic predation is bad for the welfare of the community is certainly not a preserve of left-wing ideologues or Benthamite utilitarians – on the contrary, it is precisely the issue raised by Prescott and Parente, Krueger, Buchanan. Tullock and other writers generally to the right of the political spectrum when discussing rent-seeking and unproductive activity. At this point, therefore, one would expect to find Posner on the side of the consumer welfare standard (monopoly profit should be zero so that all resources in the economy, wherever allocated, earn their competitive rate of return and no more; this should lead to optimal resource allocation as free agents seek out the highest-yielding allocations without fear of being expropriated)[63].

In his Chapter 4, however, Posner (at least on a superficial reading) presents without qualification the total surplus standard, which might seem to imply the exemption of private monopoly rent from regulation by the minimal state.

On inspection, it turns out that Posner's treatment of monopoly rents as a socially-neutral transfer in Chapters 3 and 4 is not a positive claim but simply part of a rebuttal argument against Benthamites, Kantians, Rawlsians and others arguing for redistribution from rich to poor. Posner's position (at least as stated in his 1981 book) is not that policymakers ought to adopt a total surplus standard in evaluating mergers. It is simply that antitrust policy ought not to be used as a vehicle for income redistribution based on utilitarian arguments, because there are other more efficient ways to achieve purely redistributive ends. This picks

[62] Posner (1976) also develops this theme.
[63] The argument here abstracts from the possibility of externalities and spillovers.

up familiar arguments made long before by Musgrave (1959) and Friedman (1962), but it does not amount to an argument for the efficiency defence *per se*.

For such an argument it is necessary to turn to Bork whose 1978 book *The Antitrust Paradox* has cast a long shadow over discussions of monopoly rent transfers and the efficiency defence. Bork's argument for setting aside the rent transfer when evaluating mergers runs as follows (1978 pp.110-111):

> The model outlined addresses the total welfare of consumers as a class. It says nothing of how shares of consumption should be allocated through changes in the distribution of income. Yet all economic activity has income effects and, in particular, restriction of output by the exercise of monopoly power has income effects not taken into account by weighing only changes in allocative and productive efficiency. If the reader will look once more at [Figure 2 above] he will see that at the competitive price P_1, there is a large area under the demand curve that lies above the market price. This area represents the amount above the actual price that consumers would be prepared to pay rather than go without the product; it is generally called the "consumer's surplus", perhaps on some notion that the consumer gets surplus value for his money.
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> Those who continue to buy after a monopoly is formed pay more for the same output, and that shifts income from them to the monopoly and its owners, who are also consumers. This is not dead-weight loss due to restriction of output but merely a shift in income between two classes of consumers. The consumer welfare model, which views consumers as a collectivity, does not take this income effect into account. If it did, the results of trade-off calculations would be significantly altered. As Williamson notes, referring to his diagram, "The rectangle … bounded by P_2 and P_1 at the top and bottom respectively and O and Q2 on the sides represents a loss of consumers' surplus (gain in monopoly profits) that the merger produces … Inasmuch as the income distribution which occurs is usually large relative to the size of the dead-weight loss, attaching even a small weight to income distribution effects can sometimes influence the overall valuation significantly.
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> The issue is not crucial, perhaps, since most antitrust cases do not involve tradeoff. The law's mistake has generally consisted of seeing restriction of output where there is none, and in such cases there will be no loss of consumer surplus. But even in cases where the trade-off issue must be faced, it seems clear the income distribution effects of economic activity should be completely excluded from the determination of the antitrust legality of the activity. It may be sufficient to note that the shift in income distribution does not lessen total wealth, and a decision about it requires a choice between two groups of consumers that should be made by the legislature rather than by the judiciary.

Much of the above passage involves rhetorical devices which obscure the issue – for example Bork's proposition that since the monopoly's owners "are also consumers", a transfer from consumers to the monopoly is "merely a shift in income between two classes of consumers"; and his reference to "the law's mistake" which turns out to relate to situations where the analysis does not apply in any case. Bork's substantive argument is that society's total wealth is not lessened by transfers, that any transfer is purely a matter of distribution between two putatively-equal groups of citizens (not, with due respect to Bork, performing the functions of "two groups of consumers" and hence best not described as such) and that distributional choices of this kind are the task of the legislature, not the courts.

Three points deserve to be made about this argument. First, the premise seems wrong: monopoly rent-taking does reduce total wealth, both as an empirical matter (see the discussion earlier in this paper) and as a matter of theory in even Nozick's and Posner's theories of the minimal state. Certainly one would not wish to pursue without pause the logic of an argument which fails if this premise is not accepted. Since the total surplus standard requires acceptance of precisely this premise, it is hard to see how it could be sustained on the Borkian logic without some evidential or theoretical basis for the premise. The essential fallacy to which the Bork argument has fallen prey is the notion 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.

Second, the constitutional allocation of distributional matters to the legislature is a perfectly legitimate procedure – but having accepted Bork's argument and conceded, without qualification, the legislature's right to redistribute as it sees fit, one is bound to respect the result as representing a legitimate end[64].

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[64] The point is well made by Moore (2003) pp.1217 and 1220: "Both libertarians and liberals …[do not] disagree that there ought to be at least one important collective decision about the nature and content of the individual rights that the collective, acting through government, has an obligation to protect and vindicate. They both recognize that there is enough social interdependence among individuals to require some collectively established institution to regulate relationships among individuals, as well as those between individuals and collective institutions. Their crucial disagreement is about the content of the rights to be provided to individuals to secure the appropriate amount of individual freedom and dignity, and more specifically, how much collectivization and redistribution of material assets attaches to the appropriate conception of individual rights.:..

There must be some confidence in the purposes and capabilities of our governing institutions; otherwise, individual and collective life becomes impossible, as does any idea of effective or efficient public administration of the collective (whether for narrow or broad purposes of the state). We have to believe that when we pass a law, or make an administrative ruling, or simply act in individual cases using the powers

Economists adopting Bork's position can usefully assist in identifying the most efficient means of implementing the legislature's distributive decisions, but they can surely not criticize the ends once the legislature has spoken. In this context one response which must be logically unavailable to economists would be to claim, in response to a legislative redistribution decision, that redistribution could reduce total community wealth – for example, by perverse incentive effects associated with taxes and transfers – because rejection of precisely that proposition was the premise of the Bork argument.

Third, in selecting the most efficient possible means of financing distributional transfers to countervail the exercise of market power, the legislature would surely be wise to raise any necessary revenues by a non-distorting tax if possible, which is to say, a lump-sum tax with no allocative consequences. In this case the most immediately obvious source of revenue for redistribution is the monopoly rents, which on the Borkian view can be taxed away without disturbing the allocation of resources. If the rent transfer itself is considered to be completely neutral in its impact on social welfare, its reversal must be equally so, unless there is some part of the economic argument not included in Bork's statement of it.

This suggests a final reflection. The main transaction costs incurred by a tax authority mandated to collect accurately-targeted lump-sum non-distorting taxes would be the costs of acquiring and analysing the relevant information – precisely the same problem that accounts for the bulk of the costs of a price regulator. Tax authorities traditionally have important informational advantages over other agencies of the state when dealing with commercial enterprise and have long ago resolved the issues of confidentiality and impartiality that still bedevil price-regulatory hearings. The traditional separation of the regulatory function of the state from its revenue-gathering function may thus be inefficient from a transaction-cost perspective. That is to say, the argument frequently heard for integrating the income-transfer system with the tax system would seem to apply with greater force to the regulation of monopoly rents.

Particularly in utility industries with complex tariff structures such as electricity, gas and telecommunications networks, the regulatory issue is to cap profits rather

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and assets of the state, we are producing something that the collective wants to be produced. Otherwise, there can be no appropriate state action.

I emphasize this point because I want to argue that if a collective defines public purposes by acting through political, legislative, executive and judicial means, then the values, purposes and goals defined in these processes become a different standard for judging what is publicly valuable than the simple aggregation of the welfare of those affected by the public policies. In an important sense, our legislative, executive and judicial branches set out what could be described as 'public purposes' (or in more economics-oriented language, 'social maximands') when they pass a law, issue an administrative ruling, or make a precedent-setting judicial decision., At each of these moments, a representative government institution makes a choice on behalf of a collective about an important public value that is to be protected or advanced through the use of the powers, the assets, and the capacities of the state. It is that choice that becomes the important arbiter of what constitutes public value, not the welfare of the individuals affected by the choice."

than prices, since it is profits that are the key issue. Rather than having a regulatory agency attempt to control profits indirectly via price-setting (as the Commerce Commission is preparing to do in the case of electricity lines businesses, for example)[65] it could well be more cost-effective simply to mandate the tax authorities, as part of their normal assessment procedures, to impose a 100% marginal tax rate on profits above the warranted level for certain designated activities. The task of the regulator could then be limited to that of identifying industries which are to be subject to the monopoly profit tax, and possibly of providing the tax authority with the relevant parameters.

4.3 Summing up to here

Bork's argument that redistributive ends ought to be pursued separately from antitrust policy is a reasonable (albeit not uncontested) claim to make in its own right. But it has no particular relevance to the efficiency defence for mergers. There is no need for us to delve into the vigorous ongoing debates between neoliberals and their opponents over income distribution, because those debates are quite tangential to the issue of whether monopoly rents represent a social detriment and hence ought to be included in a public benefit test for mergers and monopolistic pricing investigations.

The primary focus of a public benefits test, when evaluating the transfer component of the Williamson model, ought to be on the economic issues listed by Williamson in 1968: externalities, trends in market power at industry and national level, damaging spillovers to the democratic process (particularly, picking up the theme of a largely post-1968 literature, damage to the social and political fabric due to from rent-seeking), and various specific reasons for "not regard[ing] consumer and producer interests symmetrically" among which the two leading contenders would surely be (i) the basic proposition that consumers have a right, grounded in natural law, to freedom from monopolistic predation; and (ii) the argument from economic history that monopoly predation hurts growth, partly at least by unnecessarily raising the costs of competitive business and hence restricting long-run supply to consumers both at home and overseas.. The doctrine of prime necessity codifies the right of competitive businesses and consumers to be protected against predation, by placing an explicit limitation on the private property right of monopolists, namely that it is (or ought to be) illegal to use market power to expropriate the wealth of captive users of essential facilities.

In this spirit Hazledine (1998 p.249) has echoed Lande (1982, 1988) by suggesting that traditional antitrust and competition law may have been "intended by the legislature as a primary instrument of income distribution policy; more precisely, to *prevent* redistributions from less powerful (consumers, small firms) to more powerful (large firms) through the exercise of market power … [This] is not an argument "for" a particular income distribution – for consumers versus shareholders, or even poor versus rich. It is an argument that

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[65] Commerce Commission (2003).

the law is against having the income distribution determined by market power." [Emphasis added.]

4.4 Welfare economics, Pareto improvements: Hicks, Kaldor, Arrow and Sen

For anyone approaching the issue of mergers and monopolies from the standpoint of the present paper, it is difficult to understand how the antitrust debate became so mixed up with the separate debate over optimal income distribution. The textbooks cited earlier, however, make clear that the confusion of the two issues is pervasive. Hence it is probably necessary to review, albeit briefly, the impasse in the neoclassical theory of welfare economics which has left a large part of the economics profession so self-consciously agnostic in the face of wealth transfers, and apparently heedless of the distinction between transfers that are freely made by the will of the donor and those which are the result of coercion by the recipient.

The story[66] begins in the early twentieth century when economists generally adhered to utilitarian foundations. Pigou showed that if utility could be measured and aggregated across individuals, and if each individual's marginal utility of income was diminishing, then a case could be made that redistributing towards greater income equality would increase social welfare; from this the welfare state logically followed. Robbins and Hicks rejected the utilitarian premise of this case – in particular, the assumption that utilities could be compared and summed across individuals. With interpersonal comparisons ruled out, mainstream welfare economics ceased to provide theoretical support for the welfare state and, indeed, became very limited in its ability to say anything about how society ought to rank various feasible states of the world. The only safe proposition appeared to be that Pareto gains (one individual made better off while no-one else suffered any worsening in their position) were socially desirable. Other changes in society, involving gains for some and losses for others, fell outside the Pareto criterion and could be ranked only if some external standard of judgment was called upon.

It is important not to allow any confusion to creep in between this inability to rank states of the world when the Pareto criterion cannot be applied, and the proposition that society should be indifferent among those states. Society (in the form of whatever individuals or institutions speak for the collectivity) will clearly have strong preferences for some situations over others. All that welfare economics stated by the late 1950s was that decisions based on those preferences would have to be reached through some political procedure, not by the application of economic logic. Economists thus radically narrowed the scope of matters on which they could advise as professional economists, although they could obviously participate, as citizens (not economists), in the political process.

Two analytical issues logically presented themselves at this point. First, could a society of free individuals agree, by a democratic procedure, on a "social welfare function" to rank alternative states of the world (for example, more or less equal

[66] For detailed discussion see, for example, Hargreaves Heap 1989 Chapter 9.

income distribution)? Here Arrow's "impossibility theorem" showed that no voting procedure could on its own be relied on to deliver a fully legitimate political decision, implying that there was no theoretical reason to be sure that society at large could solve the problem which neoclassical economists had dropped into the too-hard basket.

Second, the demand by governments for economists to assist with actual decisions led to the development of sophisticated tools of social cost-benefit analysis which could be applied, for example, to project selection for investment or international-aid purposes. Cost-benefit required weights to be assigned to various categories of gains and losses falling on different parts of society, and former welfare-economic theorists (most notably Little) became embroiled during the late 1960s in a debate over the "shadow prices" that ought to be applied in evaluating social welfare. Operational convenience, combined with an institutional/bureaucratic victory won by the OECD over the United Nations Industrial Development Office, often led to pragmatic adoption by both analysts and decision-makers of the rule of thumb that "a dollar is a dollar" – in other words, that for practical purposes all gains and losses should be weighted equally, regardless of who gained and who lost[67]. This facilitated decision-making for aid agencies and enabled governments to draw up manuals for their policy analysts to follow, but did not resolve the theoretical issue of whether all groups should in fact be treated equally.

The closest to a theoretical justification that has been offered for "a dollar is a dollar" has been the Hicks-Kaldor "compensation principle", which states that a policy change can be described as a net social gain if the winners can fully compensate the losers and still come out ahead. This is appealing to practical policy-makers because it finesses the theoretical problem – not by resolving the issue, but by pretending that it doesn't exist. Proceeding as though hypothetical compensation has been paid, when in fact it has not been paid, quickly leads to absurd outcomes unless commonsense and good judgment are continually exercised.

One obvious possible application of the compensation principle, for example, could be a claim that monopoly profit-taking cannot be judged bad because the monopolist could hypothetically fully compensate the victim (by refunding the supernormal profit). (Returning to the bank robbery example, the argument would be that no social detriment occurs so long as the robber could hypothetically give the money back to the victim. A net social loss would occur only if the robber damaged the bank's property in the course of the robbery.)

[67] However, see Little and Mirrlees (1974) Chapter 13 for explicit discussion of how to apply weights to the consumption and savings of different groups; Chapter 18 for the debate between OECD and UNIDO, and p.373 for the second-best reflection that "the world as it is … does not allow an ideal distribution of goods to people". The Little-Mirrlees took as its objective the maximisation of "uncommitted social income measured at border prices" (1974 p.358), leaving open to policymakers the possibility of applying distributional weights if they wished but offering no reason in economic principle for doing so.

5. Back to the Commerce Commission

The essentials of the Williamson-Bork-Posner efficiency-defence and total-surplus arguments are to be found in the New Zealand Commerce Commission's 1994 and 1997 merger guidelines:

> Public benefits must be net gains in economic and/or social terms ("efficiency gains"). Transfers of wealth *per se* are not net gains. (p.4).
>
> The distribution of the benefits (or detriments) is not relevant to the balancing process. (p.5).
>
> It is essential … that the benefits counted be true benefits (i.e. net gains to society) and not just changes in the distribution of wealth *per se*, or transfers between areas of the country having a net impact of zero. (p.12)
>
> Recent trends in case law, and changes to the [Commerce] Act proposed by officials, are in line with the view that the Act generally does not require notice to be taken of the distributional impact of restrictive trade practices and business acquisitions. The promotion of competition, via the enforcement of the provisions of the Act, may have indirect distributional effects, and this is all that is contemplated by the Act.
>
> The underlying reasons for this interpretation are threefold:
>
> 1 Distributional issues are subjective and the Commission's view on them may have no greater validity than anyone else's. For example, there is no *a priori* reason why the *status quo* should be favoured over a new distribution of wealth; nor why a large group of the population (e.g. consumers) should be more deserving than a small group of the population (e.g. producers).
> 2 …[B]enefits accruing to only a small segment of the population ultimately will (with few exceptions) be diffused to a somewhat larger segment of the population….. Therefore, accurately establishing just who are the ultimate beneficiaries from efficiency improvements may sometimes be almost impossible
> 3 The Act contains no explicit distributional objectives. In these circumstances, the Commission and the Courts should be slow to read them into the Act, especially since the Government has access to, and utilises, social welfare and taxation policy instruments to address distributional issues.

Thus, the Commission's approach is not to apply differential weights to benefits (or to costs) according to the extent of nature of the population affected (p.14). This approach must be vulnerable to a future appeal based on the precedents set

in *Propane* and upon the new section 1A of the Commerce Act which gives primacy to consumer welfare and makes no mention of producer welfare.

6. Conclusion

A central thesis of this paper has been that the usual case for the efficiency defence and the total surplus standard, based on the arguments of Williamson, Bork and Posner, involves argument from a false premise. The false premise is that the consumer surplus standard and balancing-weights standard are no more than the application to antitrust of a contested social-democratic ideal of income redistribution from rich to poor (or in a more general sense, from the "undeserving" to the "deserving"). On this premise an argument is then constructed to show that traditional antitrust and utility-regulation policies are (i) not guaranteed to benefit the deserving, and (ii) not an efficient way to pursue purely redistributive ends. Hence wealth transfers due to monopoly pricing cannot be unambiguously held to be either good or bad, whence the safe default option is to ignore them. (The logic of this last step is weak, since an equally good case exists for evaluating transfers on their merits, albeit the standards to be used will be neither more nor less arbitrary than the practice of ignoring transfers altogether.)

Having reviewed the origins and implications of the New Zealand Commerce Commissions adoption of the total surplus standard in its public benefit test, this paper has argued in favour of a return to the conventional consumer welfare standard. The philosophical argument is that private property rights do not legitimately include a right for any individual to predate on fellow citizens. The legal argument is that the doctrine of prime necessity remains alive and that Part IV of the Commerce Act must be interpreted as embodying it. The economic argument is that incentives matter for economic growth (the maximisation of society's wealth over time) and that monopolistic predation hurts growth.

The experience of the transition economies since the collapse of the Soviet Union speaks strongly about the negative dynamic economic consequences of removing constraints on the exercise of monopoly power. The dismal performance of Africa (where both economic and military power have been little constrained by sound institutions) contrasts dramatically with that of East Asia where institutions have been framed to provide small enterprise with security.

It is worth protecting citizens from holdup not primarily because of considerations of short-run allocative or productive inefficiency, but because an economy in which monopoly power can be abused without effective restraint is likely to perform less well than one in which proper checks and balances are in place to assure the proper functioning of market forces.

The lesson from the economic development literature is unequivocal. It we take two countries which are otherwise identical in all respects, and endow one with institutional checks and balances which prevent predation of consumer wealth by natural monopolies while leaving monopoly rents uncontrolled in the other, then the first economy is predicted to exhibit better growth performance. Dynamic

efficiency, in other words, is promoted by institutional arrangements which block monopoly predation, and lessened by institutional arrangements which shield monopoly profits. The Commission's public benefits test, when applied to the case of natural monopolies, has the effect of shielding predation by holdup. That is not reconcilable with the stated intention of the *Framework Paper* (paragraphs 1.31 and 5.6) to give primary weight to dynamic efficiency considerations when considering efficiency tradeoffs. Nor is it easily reconcilable with the stated purpose of the Commerce Act 1986.

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