PROMETHEUS UNBOUND:

TOWARDS THE MORE PRECISE PROSCRIPTION
OF THE SOCIALY UNDESIRABLE MARKET CONDUCT
ASSOCIATED WITH DOMINANCE

by

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Abstract

The regulation of the market conduct of dominant firms is an entrenched part of the competition laws in many jurisdictions. The conduct which such laws proscribe has been variously described as "abuse of dominance", "anticompetitive conduct", "monopolization" or "improper use of market power". Each description is used by way of contrast to "normal competitive conduct". In all jurisdictions the courts have experienced considerable difficulty in articulating the distinction between lawful competitive behaviour and unlawful market rivalry, principally because both may exclude rivals and lead to concentrated markets, and the same conduct may be competitive or anticompetitive depending upon context.

We argue, based upon an understanding of competition as a dynamic process (a cycle of innovation and imitation), driven by rivalry between firms in which the possibility of achieving dominance is a necessary element of the dynamic, that there is no market conduct unique to dominant firms that is socially undesirable. Rather, the prospect of dominance motivates all firms to pursue either competitive or rent seeking strategies to secure the supra-normal profits attendant to a dominant position. Competitive strategies are socially desirable as they seek to meet (or influence) consumer needs and thereby promote total welfare. Rent seeking strategies are undesirable as their purpose is to prevent other firms from meeting (or influencing) consumer needs and thus represent investments in the distribution rather than the creation of wealth.

We propose the rejection of existing laws, which require proof of dominance, and their replacement by a law which proscribes rent seeking by all firms. We contend that such a law would articulate with greater precision the distinction between desirable
competitive behaviour and unlawful rivalry providing the courts with improved direction as to the evidentiary enquiry to be undertaken when a complaint of anticompetitive conduct is made. It would also relieve dominant firms from the vagaries of the uncertainties inherent in the existing approach to the regulation of market conduct associated with dominance.
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Chapter 1: Introduction: Are We Binding the Promethean Spirit?

O divine air and sky and swift-winged breezes, springs of rivers and countless laughter of sea waves, earth, mother of everything, and all-seeing circle of the sun, I call on you. See what I, a god, suffer at the hands of the gods.

The words of Prometheus bound in torment in Scythia

Prometheus Bound, Aeschylus

In Greek mythology, Prometheus brought not only fire, but also carpentry, knowledge of the stars, wings of sail, docile horses, numbers and letters, soothing remedies, indeed all the arts to mankind. Yet Prometheus, the benefactor of mankind, the bringer of technology and hope was taken, in accordance with the commands of Zeus, to the uninhabited land of Scythia, and there bound and pinned by a stake through his chest to desolate crags. Each day an eagle would come and feed on his immortal liver, which would be restored in equal measure each night. Despite this torment, the spirit of Prometheus remained unyielding. For some, the Promethean myth finds current expression in the regulation of dominant firms. Competition laws, it is argued, are cruel punishment for


2 Definition of the term "dominant firm" is central to the issues discussed in this paper. Any attempt to define what is meant by dominance raises a number of contentious questions. However, in common parlance the term "dominant firm" is used in an imprecise way to refer to any firm that is significantly larger or more powerful than its rivals in the marketplace. We will use the term in this way for the purposes of introduction. For our definition of dominance see below, c.2 - An Addendum - The Language of Competition.
those firms that bring wealth to our society\(^3\). Others are concerned to control the superior power of today's Prometheans, wary of the hope that they bring\(^4\).

Nevertheless, the regulation of the market conduct of dominant firms is an entrenched part of the competition laws in many jurisdictions\(^5\). Dominance is also the fundamental concept underlying the attempts to formulate international codes for the regulation of market conduct\(^6\). Such provisions are unique amongst competition laws.

\(^3\) Amongst those who, like Hercules, would come to slay the eagle who preys upon Prometheus are R.H. Bork, *The Antitrust Paradox* (New York: Basic Books, 1978); J.S. McGee, *In Defense of Industrial Concentration* (Seattle: University of Washington Press, 1971); D.T. Armentano, *Antitrust and Monopoly: Anatomy of a Policy Failure* (New York: John Wiley & Sons, 1982) and others of the Chicago School who argue for the repeal of most or all competition laws on the basis that dominance is the evidence of superior efficiency unless it is secured through naked cartel.


\(^5\) See Appendix 1 for a list of jurisdictions which have enacted dominance laws. We focus upon the relevant laws (and their judicial interpretation) in Australia (s.46 of the Trade Practices Act (C'wealth) 1974 [hereinafter the Trade Practices Act]), Canada (ss. 78 & 79 of the Competition Act R.S., 1985, c.19 (2nd Supp.) [hereinafter the Competition Act]), the European Community (art. 86 of the Treaty of Rome establishing the European Economic Community [hereinafter the E.C. Treaty]), New Zealand (s.36 of the Commerce Act 1986 [hereinafter the Commerce Act]) and the United States (s.2 of the Sherman Act 26 Stat. 209 (1890) as amended by 88 Stat. 1708 (1974) [hereinafter the Sherman Act]) each of which are set out in full in Appendix 2.

Whereas other provisions regulate a specific type of conduct - such as the formation of cartels, resale price maintenance, exclusive dealing, price discrimination or mergers - dominance laws regulate a specific type of firm. As to conduct, dominance laws lack specificity. The conduct which such laws proscribe has been variously described as "abuse of dominance", "anticompetitive conduct", "monopolization" or "improper use of market power". Each description is used by way of contrast to "normal competitive conduct". However, there remains considerable ambiguity as to the precise meaning of such distinctions.

An examination of the decisions in leading dominance cases in Australia, Canada, the European Community, New Zealand and the United States reveals that the courts have

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8 An expression which originates from the provision in the article 86 of the E.C. Treaty; Korah, ibid. at 55-6. It appears as a heading to ss. 78 & 79 of the Competition Act, and is a term used in the literature in Canada (Thompson, ibid; and B. Dunlop, D. McQueen & M. Trebilcock, Canadian Competition Policy: A legal and Economic Analysis (Toronto: Canada Law Book, 1987) at 201ff) although not in the decisions of the Competition Tribunal (e.g., Director of Investigation and Research v. Laidlaw Waste Systems Ltd (1992) 40 C.P.R. (3d) 289 at 331ff [hereinafter Laidlaw] and Director of Investigation and Research v. NutraSweet Co. (1991) 32 C.P.R. (3d) 1 at 33ff [hereinafter NutraSweet]).

9 See the Competition Act and decisions of the Competition Tribunal in Canada; e.g., Laidlaw and NutraSweet, ibid. It is an expression that is also used in the United States Supreme Court; e.g., Copperweld Corp. v. Independence Tube Corp. 467 U.S. 752 (1984) at 767-8.

10 See the Sherman Act. It was also formerly the marginal note describing s.46 of the Trade Practices Act.

11 See s.46 of the Trade Practices Act in Australia. The provision in New Zealand refers simply to the "use of a dominant position"; s.36 of the Commerce Act.
had persistent difficulty in articulating the dichotomy between lawful and unlawful conduct when interpreting attempts by the legislatures in those jurisdictions to regulate the activities of dominant firms. The essence of the difficulty lies in the fact that both successful competition and its abuse result in the exclusion of competitors and lead to less competition. The difficulty arises because, in regulating to promote competition, it must be recognized that the paradox of the market place is that ":[e]ach contestant strives to win, but if one of them wins completely, then monopoly comes to exist!"\textsuperscript{12} In other words

Vigorous competition 'excludes' rivals. The more successful a firm is at reducing the cost of its product or making that product more attractive to consumers, the more it sells. In the end a very successful firm will wind up with the whole market. The objective is to find ways to separate this from the kind of exclusion that injures consumers\textsuperscript{13}.

It is an objective which the courts have adopted, but have struggled to achieve.

The earliest jurisprudential attempts to grapple with the distinction occurred in the United States which has a long standing dominance law. Its terms are contained in s.2 of the Sherman Act and are rather brief and cryptic. The section provides, inter alia

\textit{Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony...}

Understandably, the cases focus upon an explication of the activity of "monopolization".

\textsuperscript{12} Shepherd, \textit{supra}, note 4 at 11.

\textsuperscript{13} F. Easterbrook, "On Identifying Exclusionary Conduct" (1986) 61 Notre Dame L.R. 972 at 973. For a discussion of how long the issue of distinguishing between competition and unlawful exclusionary behaviour has been the unresolved issue central to the regulation of socially undesirable market conduct associated with dominance; see V.H. Kramer, "Competition Chasing the Tail of Efficiency" in H. First, E.M.Fox & R. Pitofsky \textit{Revitalizing Antitrust in its Second Century} (New York: Quorum, 1991) 254.
In a landmark decision in 1945, *United States v. Aluminium Co. of America*\(^\text{14}\), Justice Learned Hand summarized the state of the law at the time in the following way:

...from the very outset the courts have at least kept in reserve the possibility that the origin of a monopoly may be critical in determining its legality...This notion has usually been expressed by saying that size does not determine guilt; that there must be some "exclusion" of competitors; that the growth must be something else than "natural" or "normal"; that there must be a "wrongful intent," or some other specific intent; or that some "unduly" coercive means must be used...What engendered these compunctions is reasonably plain; persons may unwittingly find themselves in possession of a monopoly, automatically so to say: that is, without having intended either to put an end to existing competition, or to prevent competition from arising where none had existed; they may become monopolists by force of accident...A single producer may be the survivor out of a group of active competitors, merely by virtue of his superior skill, foresight and industry. In such cases a strong argument can be made that, although the result may expose the public to the evils of monopoly, the Act does not mean to condemn the resultant of those very forces which it is its prime object to foster...The successful competitor, having been urged to compete, must not be turned upon when he wins\(^\text{15}\).

Judge Learned Hand's views were endorsed by the United States Supreme Court in *American Tobacco Co. v. United States*\(^\text{16}\). The court quoted with approval the statement by Judge Learned Hand that it does not follow from the fact that Alcoa had a monopoly "that it 'monopolized' the ingot market; it may not have achieved monopoly; monopoly may have been thrust upon it"\(^\text{17}\). To achieve the outcome of monopoly is not monopolization.

However, once it is accepted that the outcome of monopoly may be the consequence...

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\(^{14}\) 148 F.2d 416 (2d Cir. 1945) [hereinafter *Alcoa*].


\(^{16}\) 328 U.S. 781 (1946).

\(^{17}\) *Ibid.* at 786.
of desirable (and lawful) market conduct, one is left with the question what is the difference between normal competitive behaviour, which, when successful, may lead to less competition, and "monopolization". It is an issue that persists. As recently as 1984, in Copperweld Corp v. Independence Tube Corp the United States Supreme Court again expressed the difficulties in distinguishing competition from exclusionary conduct.

The same doubts arise in Australia where the High Court is yet to describe with any precision the nature of unlawful rivalry by dominant firms. The relevant provision is s.46 of the Trade Practices Act which prohibits a dominant firm from taking advantage of its market power for the purpose of eliminating or damaging a competitor or preventing competitive behaviour. In the leading case, Queensland Wire Industries Pty Ltd v. Broken Hill Proprietary Co. Ltd, Dawson J. stated

The difficulty in determining what conduct constitutes taking advantage of market power and what conduct does not, stems

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18 The earliest cases in the United States were not so generous in their treatment of existing monopolies. There were certainly cases in which the very existence of monopoly was considered to be undesirable, and prima facie evidence of the practice of "monopolization"; e.g., Standard Oil Co. v. United States 221 U.S. 1 (1911) at 75.

19 See Berkley Photo v. Eastman Kodak Co. 603 F.2d 263 (2d Cir. 1979) [hereinafter Kodak] where at 273 Kaufman C.J. described the distinction as the "fundamental tension" and "the paradox" of s.2 of the Sherman Act.


21 Ibid. Burger J. at 767-8 ("It is not enough that a single firm appears to "restrain trade" unreasonably, for even a vigorous competitor may leave that impression. For instance, an efficient firm may capture unsatisfied customers from an inefficient rival whose own ability to compete may suffer as a result. This is the rule of the marketplace and is precisely the sort of competition that promotes the consumer interests that the Sherman Act aims to foster. In part because it is sometimes difficult to distinguish robust competition from conduct with long-run anticompetitive effects, Congress authorized Sherman Act scrutiny of single firms only when they pose a danger of monopolization").

22 The provision states that a firm "with a substantial degree of power in a market shall not take advantage of that power" for any one of a number of proscribed purposes. Power is defined to mean market power in s.46(4) of the Trade Practices Act. The full text of the provision is set out in Appendix 2.

inevitably from the need to distinguish between monopolistic practices, which are prohibited, and vigorous competition, which is not. Both here and in the United States the search continues for a satisfactory basis upon which to make the distinction. For the most part, all that emerges are synonyms which are not particularly helpful. Words such as "normal methods of industrial development"; "honestly industrial", "anti-competitive", "predatory" or "exclusionary conduct" merely beg the question.24

His Honour made no express attempt to articulate a distinction that would end the search.

In Canada, where an order may be made prohibiting the practice of anticompetitive acts by a person substantially in control of a class or species of business25, the Competition Tribunal has recognized the same problems. In Laidlaw26, Reed J stated

A review of the literature indicates that attempting to establish some general criteria as to when an act or practice is anti-competitive and should be restrained, as opposed to when it is a sign of healthy or at least normal commercial competition, is not easy...To the extent that any general criteria exist they seem to require an assessment of the nature and purpose of the acts which are alleged to be anti-competitive and the effect which they have or may have on the relevant market. An analysis is required which takes into account the commercial interests of both parties served by the conduct in question and the degree of restraint or distortion of competition which results.25

The European cases also address similar issues. In attempting to extract the judicial interpretation of the term "abuse" in art. 86 of the E.C. Treaty which provides that a firm shall not abuse a dominant position in the common market, Vogelenzang states

As a result we may define "abuse" in Article 86 of the EEC

24 Ibid. at 202.

25 See s.79 of the Competition Act.

26 Supra, note 8.

27 Ibid. at 333.
Treaty as "market behaviour damaging either consumers, the competitive process, or other market participants"... However, the following complication arises: the freedom to compete of any company, including dominant ones, must be recognized as one of the interests to be protected by the EEC Treaty. Competition is the fight for the consumer's dollar. If a large company obtains an order to the detriment of a smaller competitor such cannot be held per se to be undesirable under the EEC Treaty merely because of the fact that the smaller company, is indeed, "damaged".

Again, in New Zealand, which has a dominance law that is similar to the Australian provision, the courts have struggled with the distinction between competitive conduct and an improper use of a dominant position. In one of the first cases under the provision (a relatively recent addition to the law in New Zealand), Tipping J. observed

I would venture the following proposition. It is not a breach of s.36 if a person, albeit with a dominant position, simply acts in a competitive manner. It would be an irony if such conduct could be attacked because it is competition which the Act is designed to promote...The line may well be a fine one in certain cases but it will be a matter of fact and degree and ultimately of judgment in the individual case whether the line between what one might call legitimate competition and illegitimate competition has been crossed.

It is evident that in each jurisdiction the courts recognize that accurately distinguishing between lawful competitive behaviour and unlawful market rivalry is a key issue in interpreting the dominance law. However, the judicial decisions are singularly

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28 "Abuse of a Dominant Position in Article 86; The Problem of Causality and Some Applications" (1978) 13 Common Mkt L.R. 61 at 64.

29 See s.36 of the Commerce Act which provides "No person who has a dominant position in a market shall use that position" for any one of a number of proscribed purposes. The full text of the provision is set out in Appendix 2.

30 New Zealand Magic Millions Ltd v. Wrightson Bloodstock Ltd [1990] 1 N.Z.L.R. 731 at 761 where the High Court also cited with approval the passage from the judgment of Dawson J. in Queensland Wire, supra, text relating to fn. 23. See also the reasoning of the New Zealand High Court in Union Shipping New Zealand Ltd v. Port Nelson Ltd [1990] 2 N.Z.L.R. 662 [hereinafter Union Shipping] at 706ff.
unhelpful in articulating the distinction. It is this issue that we address in this thesis, viz. precisely what is the socially undesirable market conduct associated with dominant firms (if any) and how may it be distinguished from ordinary competitive behaviour.

We argue that the undesirable market conduct associated with dominance can be precisely identified only once the concept of competition is properly understood. Under the influence of modern economic theory, a static view of competition pervades the jurisprudence. Instead, we emphasize the fact that competition is a dynamic process (a cycle of innovation and imitation) which is driven by the opportunity for competitors to earn additional profits by pursuing strategies which place them in a position of relative freedom from competitive constraint (market dominance) - at least for a time. By competing, firms increase the total welfare of society because profits are to be made in serving the needs of consumers at a lower price than their rivals. Where there are competitive markets, pursuit of the private goal of profit maximization promotes the public goal of maximizing total welfare. We conclude that as the opportunity to achieve dominance, at least for a time, is an integral part of the way the process of competition promotes total welfare, dominance is socially desirable.

However, profits may also be made by firms preventing rivals from supplying consumer needs in competition with them, an activity which reduces total welfare. Economists describe such behaviour as rent seeking. Such behaviour reduces total welfare. It is the prospect of dominance that motivates rent seeking. Therefore, both competitive behaviour and rent seeking are associated with dominance. But, whereas competitive behaviour is desirable because it serves consumer needs, rent seeking is undesirable because it consumes resources in the non-productive activity of preventing rivals from meeting
consumer needs more efficiently.

Nevertheless, although dominant firms have a substantial motive to invest in rent seeking practices to prevent the erosion of the additional profits they already enjoy by reason of their relative freedom from competitive constraint, any firm may be motivated to pursue rent seeking practices if it believes that it will be able to secure a dominant position as a result. Therefore, the practice in the market place of the socially undesirable activity of rent seeking will not be limited to dominant firms\textsuperscript{31}. Further, although dominance is often viewed in pejorative terms because it is said to effect inequitable distributions of wealth and power by concentrating both in the hands of dominant firms, we argue that, properly understood, the process of competition, though it may result in dominance for a time for successful firms, in fact operates to both build and break down dominant positions because the substantial profits earned by dominant firms in turn attracts strong competition. The real concern is not conduct of dominant firms per se, but the way dominance motivates investment in strategies designed to exclude competition. We argue that the distinction between such rent seeking behaviour on the one hand and innovation and imitation (competitive behaviour) on the other hand is the answer to the difficulty which the courts have experienced in interpreting dominance laws. We explore in detail the notion of rent seeking behaviour and how it may be distinguished from "ordinary" competition. We conclude by proposing a law which proscribes rent seeking by all firms to replace existing dominance laws.

Such a law has a number of advantages. Like other competition laws, a law which

\textsuperscript{31} The fact that a position of dominance facilitates certain rent seeking strategies is discussed in detail below, c. 5 - Strategic Motive and Advantage. However, it remains possible for non-dominant firms to pursue rent seeking strategies in other contexts.
proscribes rent seeking applies to a specific type of conduct rather than a specific type of firm. As a result it forms part of a law which outlines a code of acceptable competitive behaviour for all firms. It does not require a conclusion to be reached as to the "relevant market" an enquiry which is productive of much uncertainty and cost in dominance cases.

In sum, we reject the tendency to view market dominance in pejorative terms. Such dominant firms ought not be subjected to the vagaries of a rule which fails to distinguish with any precision between acceptable and unacceptable market conduct. To that extent we argue for the release of today's Prometheans from the torment of existing regulations which fail to recognize adequately that market dominance may be the outcome of a superior ability to meet the needs of consumers in the market place, an ability that is socially desirable.

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32 See A. Bollard & D. White, "The Interface Between Law and Economics in the Context of the Commerce Act 1986" in R.J. Ahdar, ed., Competition Law and Policy in New Zealand (Sydney: Law Book Co., 1991) 4 at 52 ("Economic and legal analysis of the "market" concept has bedeviled competition law litigation and commentaries"); and Dunlop, McQueen & Trebilcock, supra, note 8, at 230 describe the enquiry as the relevant market as "the always-difficult task of defining the appropriate market, of determining the market share..., and of examining other indicia of market power". These issues are considered in more detail below, see c.6 - Applying the Model Law.

33 There are substantial penalties for the breach of dominance laws. The level of fines are; in Australia and New Zealand up to $5,000,000 for corporations and $250,000 for individuals; in Canada, up to $10,000,000; in the European Community fines of up to 1 million ECUs or 10% of the turnover for the previous year of the offender (calculated to include the turnover of all subsidiaries - Re "Pioneer" Hi-Fi Equipment [1980] 1 C.M.L.R. 457) and in the United States $1,000,000 for corporations and $100,000 for individuals. Civil actions for damages are also possible (including actions for treble damages in the United States). Injunctions, divestment and other remedial orders with substantial commercial consequences may also be ordered in all jurisdictions.
Chapter 2: What is Competition?

One of the striking aspects of economics in informing competition policy is that it does not advance a definition of competition. To some degree that fact is unremarkable. After all competition is a relatively simple concept embracing the idea of rivalry between buyers and sellers in the market place. Buyers and sellers negotiate between each other as to all of the attributes of a good or service that may be exchanged between them such as quality, function, terms of payment, liability for defects, time and place of delivery and price. In doing so they take into account similar activities by rival buyers and sellers. They compete with each other.

The origins of economics lie in the study of competition as such a behavioral phenomenon. The notion of competition as rivalry was adopted by Adam Smith in the *Wealth of Nations*. However, under the influence of Cournot and others competition

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34 Dunlop, McQueen & Trebilcock, *supra*, note 8, at 1-2. R.C. Bernhard, "Divergent Concepts of Competition in Antitrust Cases" (1970) 15 Antitrust Bulletin 1099 describes the diversity of meaning given to the term competition by lawyers, economists and businessmen in the following terms "Competition is a standard by which the law judges the legality of many business practices; competition is an abstraction which economists use to pass judgment on economic institutions and policies; competition is a plague upon firms who feel their share of the market is insecure. Competition is a protection for consumers and a charter of freedom for individuals and firms in their productive activities. Competition is a law of nature. Competition is a violation of moral and ethical principles, a destructive, vicious and unscrupulous form of economic aggression. It is all these things in addition to being the economist's technical specification for perfection in economic life; and, at other times, the economist's description of a reality that is far from perfect".

35 *An Enquiry into the Nature and Causes of the Wealth of Nations* (Dublin: Whitestone, Chamberlaine, 1776). G.J. Stigler, "Perfect Competition, Historically Contemplated" (1957) 65 J. Pol. Econ. 1 at 1-2 credited Smith with establishing competition as the pervasive concept upon which economics was subsequently built. He described Smith's use of the term competition as follows " 'Competition' entered economics from common discourse, and for long it was connoted only the independent rivalry of two or more persons. When Adam Smith wished to explain why a reduced supply led to a higher price, he referred to the 'competition [which] will immediately begin' among buyers; when the supply is excessive, the price will sink more, the greater 'the competition of the sellers, or according as it happens to be more or less important to them to get immediately rid of the commodity'. It will be noticed that 'competition' is here (and usually) used in the sense of rivalry in a race - a race to get limited supplies or a race to be rid of excess supplies. Competition is a process of responding to a new force and a method of reaching a new equilibrium." P.J. McNulty, "A Note on the History of Perfect Competition" (1967) J. Pol. Econ. 395 at 396-7 subsequently offered a
came to be associated with the state of affairs in which every action by a seller could be matched by a rival; pure or perfect competition\textsuperscript{36}. McNulty explains the distinction between Smith's original perspective of competition and that which became the focus of economic study through the model of perfect competition as follows.

The concept of competition, originating with Cournot, on the other hand, is totally devoid of behavioral content. This is because Cournot's focus was entirely on the effects, rather than the actual workings, of competition\textsuperscript{37}.

The problem was that in focusing upon effects, competition was assumed out of the equation. Within the constraints of the model of perfect competition there could be no competitive behaviour. Indeed the description "perfect competition" is something of a misnomer in that it describes not the process of competitive rivalry, but the theoretical result once all opportunities for competitive behaviour have been exhausted\textsuperscript{38}. In short "if the state of affairs assumed by the theory of perfect competition ever existed, it would not only deprive of their scope all the activities which the verb 'to compete' describes but would make them virtually impossible"\textsuperscript{39}.

The legacy of the model of perfect competition has been a tendency amongst policy makers to ignore the essential role which the potential for a relative absence of competition


\textsuperscript{37} McNulty, \textit{supra}, note 33 at 398.

\textsuperscript{38} P.J. McNulty, "Economic Theory and the Meaning of Competition" (1968) 82 Q.J. Econ 639.

plays in the process of competition\textsuperscript{40}. The significance of the distinction between the process of competition (or competitive behaviour) and the theoretical outcome if competition is pursued to its logical extreme (or the state of perfect competition) is not always articulated by economists or understood by lawyers. It is a distinction that lies at the heart of competition policy. In particular, it is the key to understanding the rationale behind the current regulation of market conduct of dominant firms. To the understand the significance of the distinction it is first necessary to comprehend the nature and function of the market system and the way competition operates as its driving force.

The Market System

Competition policy is informed by a view of markets as the most effective mechanism\textsuperscript{41} for optimizing the welfare of its citizens by maximizing the total value of goods and services produced by that society\textsuperscript{42}. Although there remains underlying


\textsuperscript{41} By the term "mechanism" we refer to the means by which a society decides what commodities to produce from its available resources and in what quantities. Alternatives include competitive markets, bureaucracies or customs. Although one mechanism may be dominant, societies use a number of mechanisms. In a market economy, firms exist because of the efficiencies associated with bureaucracy; R.H. Coase, "The Nature of a Firm" (1937) 4 Economica 386. Indeed the trend towards larger firms in the latter part of the twentieth century can be seen as a consequence of the efficiencies to be derived from the planning of good management; Peter F. Drucker, Management: Tasks, Responsibilities, Practices (New York: Harper & Row, 1985) at 11-26. As to the role of customs in the allocation of resources see Manning Nash, Primitive and Peasant Economic Systems (Scranton, Penns: Chandler, 1966) and Robert L. Heilbroner The Making of Economic Society 6th ed. (Englewood Cliffs, N.J.: Prentice Hall, 1980), 24-44. Customs continue to have a role in "market" economies. They are seen in the way families distribute income between family members.

\textsuperscript{42} Whilst we adopt such a perspective for our present purposes, we note that there are at least four criticisms to the assumption that welfare is optimized by maximizing the total value of goods and services. First, there are limits to growth; D.H. Meadows et. al. The Limits to Growth (New York: Universe Books, 1972) and F. Hirsch, The Social Limits to Growth (London: Routledge, 1977). Second, technology and growth, though improving the quantities of goods and services produced by society result in significant spillover effects, particularly in terms of environmental impacts and social dislocation, which are ignored by a preoccupation with increasing the total value of goods and services produced by an economy; E.J. Mishan,
philosophical support for markets as an expression of the individual rights and freedoms consistent with a liberal view of democracy, amongst regulators the case for competitive markets is most commonly made in terms of economic welfare. With the collapse of communism, competitive markets are championed as the most efficient means of maximizing wealth from scarce resources.

Today, most governments adopt the market as the primary mechanism by which to allocate resources. The total welfare of all citizens is seen as being maximized by

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45 Recent developments in Eastern Europe witness a marked swing from planned to market economies. The popular press has portrayed the winds of change sweeping Eastern Europe and the Soviet Union as the fallout of the failure of planned economies to match the wealth generation of market economies. However, there is far more to the dynamics of "successful" Western economies than the market mechanism alone. Indeed many so-called Western market economies exhibit substantial government regulation. There is empirical data that questions the superiority of an unregulated market over central planning as a generator of wealth; see the survey of empirical research by P. Murrell, "Can Neoclassical Economics Underpin the Reform of Centrally Planned Economies?" (1991) 5 J. of Econ. Persp. 59 and the comparison between private and state owned firms in A.E. Boardman & A.R. Vining, "Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed and State Owned Enterprises" (1989) 32 J. of Law & Econ. 1.

46 We use the term "total welfare" to refer to the aggregate production of goods and services within an economy. In doing so we do not reject the critiques of such productivity measures, supra, note 42. Rather, we contend that such a definition reflects the limited public policy objectives of competition laws directed
competition between buyers and sellers in the market place. In general, it is believed that where there is competition there is no need for government to control or organize private industry to ensure that the correct amount of each good and service is produced at the lowest cost. Competition will do the job far better than any bureaucracy. The collective demands of every person in the market place act like an "invisible hand" to direct business to produce that which is most needed by society. Further, provided that there is adequate competition, the pursuit of self interest by individual firms, in the form of profits, will ensure that goods and services are supplied by those firms producing the best product at the lowest price, thereby serving the public interest of using resources as efficiently as possible. Competition between buyers will ensure that the market price reflects the benefit to consumers of those goods and services. Firms continually adjust their production of goods and services to respond to the demands of their customers. Those that do not will go out of business. The process of competition is the means to the desired end of increasing the total welfare of the community.

An understanding of the outcomes produced by the process of competitive rivalry is derived by economists through the model of perfect competition. As we have seen the model assumes a market in which each firm faces an immediate response by a rival to any action which it takes. In a perfectly competitive market there is an identical product made by all firms; there are numerous buyers and sellers so that no single firm or customer can influence prices; there are no transaction costs; all participants are aware of all information relevant to the transaction; and firms may freely enter or exit the market at any time. Such assumptions mean that there is the potential for all buyers and sellers to become aware of at making the market work as effectively as possible. There are other policy instruments concerned with the broader issue of wellbeing in society; see below c.3.
the cheapest method of producing the product and that there is a finite limit upon the competitive rivalry that may take place in that no new product may be developed by the sellers\(^47\). However, within the constraints of the assumptions it is possible to establish that, over time, the process of competition within such a market will reach an equilibrium where the cost of production (including normal profits\(^48\)) equals the value to the marginal consumer; or the market price. If above normal profits are earned new firms will enter the market; if lower than normal profits, firms will leave. Any firm selling at a price equal to the cost of production will sell all of its output. Firms charging a higher price will make no sales; firms charging a lower price will have an incentive to leave the industry and make better profits elsewhere or will go out of business. It is not possible to charge different prices to different buyers, because all buyers know that the product is the same. If too much of the product is produced then the price will fall forcing firms out of the market; if too little is produced the price will rise and new firms will be encouraged to enter. As all participants are aware of all relevant information, all sellers are able to imitate any cost saving methods of production adopted by other sellers, and all buyers are aware of the cheapest seller.

The market tends toward an equilibrium which occurs at the point where the price


\(^48\) Normal profits are part of the costs of production. They represent the average return on capital that may have been expected from a similar investment. As such they are the cost forgone (or the opportunity cost) of an investor in putting time and money into the firm. In a small business, normal profits are often simply the cost of the proprietor’s labour.
of the product equals both its value to the last customer and its cost to the firm. There is then no change that can be made to increase welfare and as a result not only does the management of the firm ensure that the product is produced as cheaply as possible (ensuring internal efficiency\textsuperscript{49}), but allocative efficiency is also reached\textsuperscript{50}. That is to say, there is no better use that can be made of the resources that are being expended to produce the product. It is that single price which a perfectly competitive market sets, and is the price at which all sales will take place. At that price all customers will buy and all firms will sell. At a higher price no customers will buy. At a lower price no firm will sell. The state of perfect competition reaches equilibrium at the point of maximum internal and allocative efficiency.

However, the constraints of the model are such that once equilibrium has been reached the process of competition has been exhausted\textsuperscript{51}. There is nothing that a seller can do to distinguish its product from that of its rivals, and all buyers are aware of that fact. A perfectly competitive market in equilibrium exhibits none of the dynamic rivalry which has driven the market to its efficient goal. The insight of the model of perfect competition is that, taken to its logical extreme, the process of competition produces a market in which

\textsuperscript{49} Internal efficiency is maximized when commodities are produced as cheaply as possible; Shepherd, \textit{supra}, note 4 at 18. The term "productive efficiency" is also used to describe the same measure. It is a static measure because it refers to the maximum that may be produced by a firm from available inputs. It is the outcome of excellent management over time. It is to be distinguished from "dynamic efficiency" which refers to the additional output that may be produced from available inputs through the process of change, or innovation, over time.

\textsuperscript{50} Allocative efficiency is maximized when there is no improvement that can be made in the total value of goods and services that may be produced from available resources by reallocating them from the production of one commodity to another. For a full statement of the theoretical analysis that perfectly competitive markets lead to the maximization of allocative efficiency see W.J. Baumol, \textit{Economic Theory and Operations Analysis}, 4th ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1977).

\textsuperscript{51} McNulty, \textit{supra}, note 38 at 642.
internal and allocative efficiency are both maximized. For a significant period the implication of the model was thought to be that regulators must adopt policies which produce, as near as possible, the state of perfect competition. However, such a conclusion assumes that there can be no increase in total welfare through "imperfections" in the marketplace that result in additional profits for firms due to something less than perfect competition. In fact, a proper understanding of the dynamic nature of competitive behaviour reveals that periods of imperfection are an inherent part of the way the process of competition increases total welfare.

Understanding Competition

One way of understanding competitive behaviour and its effects is to consider the effect of an absence of competitive rivalry in the marketplace. This has traditionally been the approach of economists - comparing the insights of the model of perfect competition with the model of monopoly in order to understand the effects of competition. Of course, a monopoly is a market in which there is a complete absence of competitive behaviour. If a monopolist increases the price for its product then the only choice for buyers is to pay the additional price, or not to buy the product at all. Indeed, a monopolist has every incentive to increase price above the equilibrium price that would result from perfect competition. Its profits will be maximized where the marginal cost of producing an additional product equals the marginal revenue to be obtained from selling that product. The marginal revenue will always be something less than the monopolist's average revenue.

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53 See, for example, Stigler, supra, note 35 at 5-22.
(which itself will be equal to the demand for the product, because all of the product is supplied by the monopolist\textsuperscript{54}). Any additional products produced after the point where marginal cost equals marginal revenue will produce less revenue for the monopolist than they cost to make causing a reduction in profits. The result is that the most profitable option for a monopolist will be to sell less at a supra-competitive price\textsuperscript{55}. In doing so the monopolist extracts supra-normal profits\textsuperscript{56}.

Supra-competitive pricing has three immediate consequences. First, it increases the price to consumers. Secondly, it results in producers\textsuperscript{57} receiving a greater share of the difference between the cost to produce the product and the benefit to the buyer of the product. As this difference is generally known as the "total surplus", it is usual to describe this second effect of monopoly pricing as a transfer of surplus from consumers to producers. Thirdly, as the price increases, some consumers\textsuperscript{58} buy substitutes when it would be more cost effective for the needs of those consumers to be met by the purchase of the original product at a competitive price. So, monopoly pricing also causes inefficiency in the

\textsuperscript{54} We assume that all of the product is sold at the same price. The same general principle applies if different prices are charged to different customers, although the analysis would be more complex.

\textsuperscript{55} In it usual to refer to the practice of pricing above the price that would prevail in a perfectly competitive market as monopoly pricing. However, monopoly pricing has pejorative overtones. The term also suggests that it is associated with the practices of large firms controlling a market for an extended period. Our argument is that the practice of "monopoly pricing" is part of the process of competition and as such has a benign effect as part of the dynamic of competitive rivalry. The basis for this conclusion is developed in the balance of this chapter. We therefore adopt the more neutral term "supra-competitive pricing" to describe the practice of pricing above the competitive equilibrium price and the term "supra-normal profits" instead of "monopoly profits" to describe the additional revenue to be earned form such a practice.

\textsuperscript{56} Baumol, supra, note 50 at c.16; Dunlop, McQueen & Trebilcock, supra, note 8 at 85-8.

\textsuperscript{57} Market power would be shared between firms in the case of a cartel, or in the case of conscious parallel behaviour in an oligopoly.

\textsuperscript{58} Those at the margin, for whom the difference between cost and benefit is only small and therefore for whom a small increase in price will result in the price exceeding the benefit to them of the product.
allocation of resources or dead weight loss.

Further, these three outcomes are interconnected. As the price for consumers is increased above that which would otherwise prevail in a competitive market, the price exceeds marginal cost by an increasing amount giving producers an increasing share of total surplus. As a result, consumers pay more and so lose some of the benefit of their purchase, that benefit being transferred to producers. Those consumers at the margin now find that the product costs more than it is worth to them and buy other products. In fact they would prefer to buy the original product if the lower market price prevailed. These "second best" purchases, caused solely by the price increase, are inefficient because the same need could be met at a lower price if the competitive market price still prevailed for the original product. Finally, for a monopolist there is no longer any competitive pressure to keep costs to a minimum. The costs of a monopolist tend to be higher than those of firms selling in competitive markets, a phenomena referred to as X inefficiency\(^59\). From the perspective of the goal of maximizing total welfare, the equilibrium which results from an absence of competition is internally and allocatively inefficient. In short, the monopolist is better off, but society and consumers are worse off.

It is evident that the concepts of monopoly and perfect competition represent two theoretical extremes. In the case of a monopoly there is no competitive behaviour in the market. In the case of perfect competition the potential for competition has been exhausted. A monopoly is allocatively inefficient, a perfectly competitive market maximizes allocative efficiency. It is at the point of attempting to understand what lies between the

\(^{59}\) X inefficiency describes the particular internal inefficiencies associated with monopoly; see H. Leibenstein, *Beyond Economic Man* (Cambridge, Mass.: Harvard University Press, 1976) c.3; and Dunlop, McQueen & Trebilcock, *supra*, note 8 at 60-4. The effects of X inefficiency are discussed in more detail below; see c.3.
two theoretical extremes that the consequences of the failure of economics to define precisely what is meant by competition become starkly apparent. From our discussion it appears that the way a market in which the state of competition is close to monopoly may be changed to a market in which the state of competition is close to perfect competition is the process of competition - that is rivalry between firms. Indeed, one might conclude that there is simply an inverse relationship between the level of competition and the ability to charge supra-competitive prices - as competition increases the ability to charge supra-competitive prices is gradually eroded, leading to increased internal and allocative efficiency.

However, the simplicity of such a conclusion ignores the dynamic nature of competitive behaviour. The process of competition itself changes the state of competition in the market place. Indeed, the paradox of competition is the fact that it is the opportunity to earn the supra-normal profits of monopoly that encourages firms to compete and thereby increase the state of competition\textsuperscript{60}. The potential for monopoly is the means to perfect competition. It is this paradox that moulds competition policy in general, and the regulation of dominant firms in particular. It is the key to the formulation of effective competition laws.

The Paradox of the Process of Competition

The process of competition is best viewed from the perspective of the seller since,

\textsuperscript{60} Compare, Shepherd, \textit{supra}, note 4 at 11 ("There lies a troubling paradox: Each contestant strives to win, but if one of them wins completely, then \textit{monopoly} comes to exist! Even a partial victory (say a market share of 70 percent) creates a degree of monopoly. That outcome of competition itself moves the market away from competitive conditions, and it will prevent effective competition in the future. In contrast, effective competition requires an enduring balance of power, so that many comparable competitors continue, neutralizing one another. Therefore, each competitor must win enough to reward its best efforts, but not enough to eliminate of even dominate the other competitors. Any market power it does obtain must not last very long").
ultimately, it is the seller that decides whether to offer a product for sale in the marketplace. Further, it is the likelihood that sellers will supply, at the lowest possible price, the goods and services that are most desired by buyers that will maximize total welfare. Although this involves buyers signal their preferences to sellers in a cost effective manner, if sellers are competing with each other to meet buyers’ needs we can expect the interest of society in maximizing total welfare to be served. Therefore, although it is the interaction between buyers and sellers motivated by their own interests that produces competition, we adopt the perspective of the seller in examining the process of competition.

Sellers aim to maximize their profits. The state of perfect competition reduces profits to a minimum level, or normal profits. Porter expresses the impact of the process of competition upon profitability as follows

Competition in an industry continually works to drive down the rate of return on invested capital toward the competitive floor rate of return that would be earned by the economist’s “perfectly competitive” industry. This competitive floor, or "free market" return, is approximated by the yield on long-term government securities adjusted upward by the risk of capital loss. Investors will not tolerate returns below this rate in the long run because of their alternative of investing in other industries, and firms habitually earning less than this return will eventually go out of business...The strength of the competitive forces in an industry determines the degree to which...inflow of investment occurs and drives the return to the free market.

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61 Of course, buyers do influence the conduct of sellers to a significant degree. It is buyer demand that dictates whether a firm will have a market for its product. As to whether buyers pose any significant threat of engaging in socially undesirable market conduct if they are in a position of dominance; see below, c.6 - Dominant Acquirers.

62 The assumption that firm behaviour will be motivated by the desire for profits is not without its qualifications in the real world. Managers, depending upon the degree to which they have a personal stake in the profits of the firm, may trade off profits for "the quiet life", security of their own position (adopting a risk averse strategy), prestige, power or philanthropic motives; Scherer, supra, note 4 at 31-3.

level, and thus the ability of firms to sustain above-average returns.\(^{64}\)

Porter goes on to argue that the strength of the various "competitive forces" - entry, threat of substitution, bargaining power of buyers, bargaining power of suppliers, and rivalry among current competitors - jointly determine "the intensity of industry competition and profitability."\(^{65}\) He equates competitive strategy with "offensive or defensive action in order to create a defendable position against the five competitive forces"\(^{66}\) and "thereby yield a superior return on investment for the firm."\(^{67}\) Ironically, we see a picture in which the competitive behaviour of firms comprises attempts to stem the tide of competition. Profitability lies in securing a position that is relatively free from competition and then defending it from attack by the forces of competition. Of course, some firms lead the way in striving to create opportunities for supra-normal profits. Some react to the actions of others when they find their business is no longer profitable.

How does this happen? The process of competition is simply the interaction between firms selling the same or similar products as they try to out bid each other in the market in order to attract buyers. Another way of expressing the dynamic is that each firm must do something which reduces the level of competition which it faces. One way is to strive to reduce its costs below those of its competitors. Another is to develop a new product, or method of production desired by customers and not available from competitors. A third is for a firm to differentiate its product from that of its rivals. The more successful

\(^{64}\) Ibid. at 5-6.
\(^{65}\) Ibid. at 6.
\(^{66}\) Ibid. at 29.
\(^{67}\) Ibid. at 34.
the strategy, the more it will reduce the level of competition faced by the firm and the more it will be able to price supra-competitively. In the following landmark passage Schumpeter\textsuperscript{68} captured the significance of the role of such innovative behaviour

\ldots it is still competition within a rigid pattern of invariate conditions, methods of production and forms of industrial organization in particular, that practically monopolizes attention. But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts but competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest scale unit of control for instance) - competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives. This kind of competition is as much more effective than the other as bombardment is in comparison with forcing a door, and so much more important that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly\textsuperscript{69}.

Once a firm establishes a competitive advantage through successfully pursuing such strategies, then one can expect existing or new competitors to imitate or better the competitive advantage that is producing supra-normal profits. In response, the original firm may seek to defend its advantage. It may do so through a patent which prevents imitation, or requiring secrecy on the part of its employees as to the source of its cost advantage, or engaging in strategic behaviour to dissuade the entry of new competitors to an existing market, or it may redouble its advertising efforts to promote an allegiance by customers to its brand.

The important point is that the process of competition is a dynamic response to the opportunity for supra-normal profits. It operates through firms introducing changes


\textsuperscript{69} Ibid. at 84-5, a process described by Schumpeter as "creative destruction".
directed at securing a competitive advantage (or relative freedom from competition) followed by rivals seeking to imitate or better the advantage. The profit incentives are such that firms will also strive to defend their advantage from the tide of competition attracted by the supra-normal profits resulting from the relative freedom from competitive pressures.

To understand the significance of the incentive of possible supra-normal profits created by the prospect of a period of less competition let us return to the world of perfect competition. Assume that a firm discovers a new method of production. The structure of the model of perfect competition requires that the discovery is immediately known to all rivals and that there are no barriers to firms immediately imitating the innovation. Within an instant any advantage which the innovator had has been eroded. Unless the costs of developing the innovation were zero, the innovator would lose out from adopting the new method of production because it would have no opportunity to recoup its investment in research and development. Viewed in another way, there is no incentive to innovate in a perfectly competitive market.  

However, the dynamic process of innovation and imitation itself substantially improves the total welfare of society. The fact that buyers are prepared to buy new products (or those produced using new methods) instead of established alternatives, shows that they are valued by society. It is now recognized that this dynamic efficiency, 

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70 W.D. Nordhaus, *Invention, Growth, and Welfare: A Theoretical Treatment of Technological Change* (Cambridge: Mass.: M.I.T. Press, 1969) at 39. This negative effect upon innovation also arises as a result of the notion of ultra free entry associated with theories of perfect contestability. There is no incentive to innovate where there is perfectly free entry and exit. Supra-normal profits will always attract entry. In this respect perfectly contestable markets have the same undesirable aspects as perfectly competitive markets in terms of promoting dynamic efficiency.

71 There are two ways in which innovation may produce improvements in welfare. First, through new methods of production, or process innovation, which leads to increases in productivity. Second, through new products that are demanded by customers, or product innovation, which increases the quality of consumption; Scherer, *supra*, note 4 at 407-8. We will use the term innovation to refer to both types of welfare improving
resulting from changes introduced by rivals in the market, stands with internal and allocative efficiency as an important way in which competitive markets increase the total welfare of society. Indeed many argue that innovation, even though it leads, for a time, to a state of less competition (and therefore internal and allocative inefficiency) will invariably confer a net benefit on total surplus.

Once the innovative nature of the competitive process is taken into account we can see that what is important for improving total welfare is not the creation of a static market in which the state of competition approaches the perfect model, but rather the encouragement of the process of competition, which may initially lead to a state of affairs where there is less competition. It is only when the position of monopoly after the innovation is taken as the starting point for analysis (thereby ignoring the role which the opportunity for such monopoly created in motivating the monopolist to innovate in the first instance) that the existence of the monopoly is seen as reducing total welfare due to the dead weight loss associated with supra-competitive pricing. But such an approach ignores the fact that without the incentive to innovate, created by the opportunity to earn supra-normal profits, the first gain in total welfare through innovative change would not have been made. Further, the existence of supra-normal profits will attract firms to attempt to overcome the advantage of the original innovator. As has been observed by others, supra-normal profits are the cost of ensuring that firms innovate. In summary, the process of change.

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72 E.g., Hay & Morris, supra, note 4 at 566-86; Dunlop, McQueen & Trebilcock, supra, note 8 at 61-4; and Shepherd, supra, note 4 at 17-23.

73 E.g., Scherer, supra, note 4 at 114-5; and E. Mansfield, "Entry, Gilbrat's Law, Innovation and the Growth of Firms" (1962) 52 Am. Econ. R. 1023.

74 Dunlop, McQueen & Trebilcock, supra, note 8 at 64.
competition through innovation results in a cycle whereby total welfare is continuously improved. The paradox is that the same incentive that drives individual firms to secure an opportunity to earn supra-normal profits through relative freedom from competitive forces will continually drive other firms to be the agents of those competitive forces and bid away those profits through the process of competition.

**Static and Dynamic Perspectives of the Process of Competition**

The models of perfect competition and monopoly exclude the effects of change. In a world without change, competition is limited to responding to the fixed demands of buyers using existing technology and known resources to produce well defined goods and services. In such a world, rivalry between firms, over time, is limited to producing the best quality goods and services as cheaply as possible. Competition is inward looking. A monopolist need not be concerned about new entrants, because the monopoly cannot be overcome through new ideas. In a perfectly competitive market a seller accepts the market price as a given. Everything that can be produced can be sold at that price. The process of competition in such a static world is limited to the issue of internal management. We have adopted the phrase internal efficiency to describe the outcome of competitive activity in such a static environment.

However, once dynamic elements are introduced the field of competitive rivalry is expanded dramatically. Buyer preferences are continuously changing. They may be influenced by advertising. The process of competition itself redistributes resources changing demand. People change. "Baby boomers" have had a dramatic impact upon the demand for certain products as they have aged. New methods of production and new products may
be invented and given competitive applications. The result is that competitors can exploit change (both by being a catalyst for change and responding to change caused by others) to create new profit opportunities. Of course, internal efficiency is still part of competitive activity. But in industries where the rate of change in customer preferences, fluctuations in the level of demand, new products and new methods of production is rapid, the profit opportunities are dramatically increased for the innovator. The profit incentive for firms to be agents of change through advertising, research and development is considerable. With change the potential for increases in total welfare, or increases in dynamic efficiency, is substantial - limited only by the innovativeness of the competitors in the market. Dynamic efficiency is so significant that it "must eventually affect standards of living more potently than differences in the efficiency of static resource allocation and utilization."  

We now see the distinction between static competition and dynamic competition. As the models of perfect competition and monopoly are static models, they portray the process of competition in static terms. Within the assumed limits of such models, over time, the process of competition leads to equilibrium because change is not possible. However, in the real world change is ever present. Competitive behaviour is dramatically influenced by change. It continually creates opportunities for profit - and in the process increases total welfare. It is the cycle of innovation and imitation that promotes total welfare.

However, the dominant images that have influenced competition policy have been

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75 Scherer, supra, note 4 at 140.

76 For an excellent summary of the distinctions see Hay & Morris, supra, note 4 at 565-70.
those of static competition within a market structure that is perfectly competitive. We contend that they ought to be replaced by a singular emphasis upon dynamic competition. By dynamic competition we mean not only innovation to earn supra-normal profits, but also the contest which is encouraged by the opportunity created by the innovator which, over time, leads to allocative efficiency. Competition is a dynamic process. It is not associated with any particular market structure as it necessarily changes the market structure. Indeed, it is driven by change.

A Definition of Competition in terms of Innovation and Imitation

Based upon the above analysis, we define innovation as change introduced by a firm. Such change may be a response to factors external to the firm, such as, for example, a shift in consumer demand or a decline in the availability (and increase in cost) of an essential input. Or the firm may be a catalyst for change through its own inventiveness or through advertising designed to influence consumer demand. The areas for potential profitable change in any business may be divided into three areas - product, production process or customer demand.

77 E.g., in Borden v. ReaLemon 92 F.T.C. 669 (1978); aff 674 F.2d 498 (6th Cir., 1982); vacated 461 U.S. 940 (1983) the remedy proposed by the trial judge was that ReaLemon be required to licence its brand name because that deviation from the model of perfect competition was the source of its market power. See also, B. Klein, "Perfect Competition as a Criterion for Antitrust Policy: Brand Names, Entry Barriers and Exclusive Dealing in the Fisher & Paykel Case" in R.J. Ahdar, Competition Law and Policy in New Zealand (Sydney: Law Book, 1991) 65 at 68 ("It is crucial to distinguish between an unrealistic assumption of a possibly useful theoretical model and an assumption as a desired policy goal. For example, a model in physics may assume a frictionless world in order to illustrate the basic physical forces at work. However, when an engineer is building a bridge, it would not make sense to pour grease over everything to see how close we can come to approximating an assumption of the pure physical model. Similarly, although the perfectly competitive model may be a useful tool of analysis for some purposes, it makes no sense to attempt to force the world into such a model by attempting to approximate an unrealistic assumption...of the model"). In his influential book, Bork, supra, note 3 at 91 refers only to productive and allocative efficiency and states "These two types of efficiency make up the overall efficiency that determines the level of our society's wealth or consumer welfare". The economic analysis which follows is expressed in static terms.
It follows that innovation is any change made by a firm in its product, its production process or its attempts to influence customers. Imitation is the activity of copying successful innovations by other firms. Competition is the dynamic interaction of the two. Successful innovations are imitated by others.

The dynamic nature of competition has often been ignored because competition has been viewed as a structural concept. That is, as a function of the extent to which the structure of the market approaches the theoretical model of perfect competition. Where there are few rivals, and little threat that new firms may contest the market, competitive conduct in the market will be low and the market will be inefficient. Within such a structure-conduct-performance paradigm the welfare benefits of competition are seen as being promoted by ensuring that there are many rivals in the market. Increasing competition is equated with increasing the number of firms in the market. Such a structural perspective must immediately be qualified to recognize that there will be cases where a concentrated market structure will be the only way to allow firms to achieve scale and scope economies and other cases where atomistic competition is not possible because products supplied by rivals are imperfect substitutes. Further, there will be little incentive to innovate where the structure of the market is such that any gain from innovation will be transitory. It follows that the type of competitive conduct that is the outcome of a deconcentrated market structure does not lead to dynamic efficiency as a matter of course. The dynamic process of competition may well be absent from a market that is structurally

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78 Hay & Morris, supra, note 4 c.2.

79 Scherer, supra, note 4 at 127.
"competitive".

Competitive behaviour must be understood as a process that transcends transitory market structures. It is a dynamic, not a structural, phenomenon.

**Competition and Dominance**

Our analysis of the process of competition leads us to an important conclusion in the context of the regulation of the market conduct of dominant firms. The most profitable and dominant firms will tend to be those that excel in creating and exploiting the potential for supra-normal profits. The potential for such profits arises where a firm develops a cost saving or a new product or method of production, or persuades a customer that there is no alternative for its product. The scope of the potential (the length of the period in which it may be exploited) depends upon the extent to which the cost saving, the new product or method of production or the change in customer perception makes the products of other firms in the market no longer substitutes in the minds of buyers. It also depends upon the ability and responsiveness of others to imitate the firm exploiting the potential and join the contest for the new profit opportunity, the ability of investors in existing technology to thwart any change to exploit the potential and the barriers which exist (or may be created) to prevent others from exploiting the potential.

In short,

There is a pervasive duality to the effects of competition on the pace of innovation. More competition stimulates and accelerates innovation within limits, but when competition becomes so intense that any given rival can anticipate appropriating only a small share of the innovator's benefits, still

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80 Clark, *supra*, note 36 at 88.
more competition retards innovation\textsuperscript{81}.

At any point in time the competitive strategy of a firm may be based entirely upon its ability to exclude competitors from exploiting the potential for supra-normal profits that it has been able to secure. As a result, an inconsistency arises. On the one hand eliminating all barriers to the ability and responsiveness of other firms to contest for the potential to earn supra-normal profits reduces the incentive to innovate and create such potential. Without a clear profit advantage such innovations will only be made where they are relatively costless or where they are necessitated by the behaviour of rivals\textsuperscript{82}.

On the other hand, the erection of absolute barriers to competitive exploitation of any potential for monopoly profits will entrench the allocative inefficiency of monopoly\textsuperscript{83}. Sustained monopoly is allocatively inefficient. It also results in X inefficiency. Arguably, there is also less incentive for a firm which is comfortably earning supra-normal profits, without threat of competition, to invest in further innovation\textsuperscript{84}.

It is evident that there must be some form of balance. It is the cycle of innovation and imitation through the process of competition that is the means by which the market system improves the total welfare of society. Although the equilibrium of perfect competition may never be reached, the competitive process continually improves total welfare through advancing internal, allocative and dynamic efficiency. The difficulty lies in


\textsuperscript{82} Of course, rivals will face the same inertia so far as innovation is concerned if, as soon as they innovate, all competitors will be able to immediately respond and imitate.

\textsuperscript{83} Economists of the Chicago School argue that the ability to sustain dominance is weak and that existing antitrust laws, for the most part, are too great a barrier to the exploitation of monopoly profits, stifling the welfare enhancing innovations that are attracted by the rewards of supra-normal profits; Bork, \textit{supra}, note 3; and Armentano, \textit{supra}, note 3.

\textsuperscript{84} Scherer, \textit{supra}, note 4 at 425ff; and Shepherd, \textit{supra}, note 4 at 37.
ensuring that there is sufficient incentive for individual firms to pursue strategies which lead to lower costs, new products and methods of production and respond to changes in consumer preferences, without entrenching opportunities to earn supra-normal profits in perpetuity from a single stratagem.\textsuperscript{85}

In part, incentive is created simply by the fact that some innovations are inherently difficult for competitors to reproduce in a relatively short period of time. It may take time for a rival to build the necessary plant or to establish an equivalent reputation in the market or to secure adequate sources of supply of inputs or distribution channels to imitate the innovation of a rival. However, other innovations are relatively easy to imitate. Unless firms are able to recoup the cost of innovating from supra-normal profits then there is no incentive to innovate and the potential increase in total welfare that would result from innovation is lost.

To summarize, it appears that it is the dynamic process of competition whereby firms innovate and imitate, rather than the state of affairs of perfect competition, that is the means by which markets increase the total welfare of a society. The process of competition involves a continuous cycle of innovation and imitation. Both elements seem to be required to increase welfare and, at any point in time, the process of competition may result in market structures that tend towards monopoly or perfect competition. What is significant is not the structure of the market, but the behaviour of the participants in the market. The promotion of competitive behaviour is materially different to the promotion of perfect

\textsuperscript{85} It is important to distinguish the case where a firm which earns supra-normal profits over a long period due to its ability to continually innovate and continually create fresh potential for supra-normal profits, even though the process of competition through imitation gradually erodes the opportunities created by past innovations from the case where a firm is able to extract supra-normal profits over an extended period of time due to some protection from competition.

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competition. Importantly, a proper perspective of the dynamics of the process of competition leads to the recognition that the prospect of dominance is an inherent part of the stimulant for competitive behaviour and it is competitive behaviour that promotes internal, allocative and dynamic efficiency.

We ought not be surprised by this conclusion. Indeed, when we consider our basic understanding of a competitive market, it is to be expected that the prospect of dominance would be an essential part of the dynamic. Markets are driven by the interactions between individual firms seeking to maximize profits and individual buyers seeking to maximize consumer surplus. Dominance is no more than the attainment of the possibility which drives the market mechanism - greater profits.

However, the effects of dominance are not exclusively benign. The market power that results from market dominance leads to the outcomes of increased prices and the transfer of surplus to the owners of dominant firms, as well as internal and allocative inefficiency. The incentive of greater profits also encourages behaviour other than innovation and imitation, which behaviour is a social cost of dominance. We have yet to consider such behaviour explicitly.

**Competition and Rent Seeking**

The process of competition is not endogenous in a free market economy\(^6\). Just as the potential for supra-normal profits can be created by innovations which give a firm a competitive advantage over its rivals, such potential can be created by excluding the

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\(^6\) At this point, we assume the validity of the argument that competition is desirable due to its ability to promote total welfare through improvements in internal, allocative and dynamic efficiency; see Clark, *supra*, note 36 c.4; and the discussion above, c.2.
process of competition from the market place. The propensity of firms to pursue such exclusionary strategies is so great that one must work vigorously to ensure the maintenance of free competition\textsuperscript{87}. Firms soon learn that the exclusion of competition can be effected through cartels, strategic behaviour to dissuade the entry of new competitors to an existing market, monopoly ownership of inputs or exclusive dealing arrangements and that it is profitable to pursue such strategies.

The impressive evidence of the prevalence of limit pricing behaviour\textsuperscript{88} suggests that many firms pursue exclusionary rather than monopoly pricing strategies which enable them to preserve, as far as possible, the potential to earn supra-normal profits from attack by the forces of competition\textsuperscript{89}.

In addition, there are markets in which the level of demand is such that the process of competition itself leads to the concentration of production in the hands of a few firms, or in some cases a single firm. Some goods or services can be produced at low cost only if produced on a large scale. These economies of scale may be so significant that it is most efficient for all or most of a particular product necessary to satisfy the demand in a market to be supplied by a single firm. Also, some goods and services can be produced at much lower cost if produced together with other goods or services by one firm. Such economies of scope may also mean that it is cheaper for a few firms, or perhaps one firm, to supply the entire market. Competition drives firms to exploit scale and scope efficiencies and in many cases leads to concentrated markets.

\textsuperscript{87} Scherer, \textit{supra}, note 4 at 23.

\textsuperscript{88} P.S. Crampton, \textit{Mergers and the Competition Act} (Toronto: Carswell, 1990) at 233.

\textsuperscript{89} \textit{Ibid.}
More generally, the process of competition itself tends to break down circumstances in which a firm faces competition from a rival supplying a product which is a direct substitute for its own product. Indeed it has been observed that the attempts by rivals to offer a product which is not available from a competitor (thereby creating the opportunity to earn supra-normal profits) itself ensures that perfect competition will never be reached.

...there are many reasons why a customer buys from one producer rather than another besides the simple one of difference in the prices which they charge, and since the rival producers make it their business to exploit all these influences upon the customer’s choice, the very existence of competition, in the plain sense of the word, ensures that the market will not be perfect. Rival producers compete against each other in quality, in facilities, and in advertisement, as well as in price, and the very intensity of competition, by forcing them to attract customers in every possible way, itself breaks up the market and ensures that not all the customers, who are attached in varying degrees to a particular firm by the advantages which it offers them, will immediately forsake it for a rival who offers similar goods at an infinitesimally smaller price.  

Finally, in markets in which production has become concentrated in the hands of a few firms, rivalry takes on an added dimension. The participants in such a market, or oligopolists, are able to pursue cooperative strategies, instead of competitive strategies in order to share the potential for supra-normal profits that would otherwise only be available to a monopolist. Such practices do not require express agreement. Competitors in an oligopoly will learn over time the profit advantages of a cooperative strategy. However,

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91 It is important to recall that our definition of "rivalry" encompasses any behaviour undertaken by a firm in pursuit of profits. It includes co-operative strategies or "friendly rivalry". Of course, there are those who advocate the welfare improving benefits that are associated with co-operative strategies in a number of contexts; e.g. T.M. Jorde & D.J. Teece, "Innovation, Cooperation, and Antitrust" in T.M. Jorde & D.J. Teece, eds., Antitrust, Innovation, and Competitiveness (New York: Oxford University Press, 1992) 47. However, our concern herein is unilateral action.
from the perspective of total welfare, such strategies are as damaging as supra-competitive pricing by a single firm. They also result in additional costs in that efforts are directed towards maintaining the cooperation between competitors resulting in allocative inefficiency.\(^2\)

The same profit motive that drives firms to innovate and thereby create an opportunity to earn supra-normal profits through relative freedom from competitive constraint, also motivates firms to pursue other market strategies, either alone or in cooperation with competitors, to reduce the level of rivalry in the market place. However, resources expended solely in creating, protecting or entrenching an opportunity to earn supra-normal profits are wasted. Not only do they fail to improve the total welfare of society, they direct resources away from productive activities causing allocational inefficiencies. Such activities are described by economists as rent seeking.\(^3\) They simply consume resources in securing the right to earn supra-normal profits. Rent seeking activities result in no productive output. They do not serve the demands of customers. They are investments solely in the distribution of profits.

However, rent seeking, like innovation and imitation, is motivated by the prospect of dominance. In other words, rivalry in the marketplace includes rent seeking. Therefore, although we have argued that dominance is a necessary part of the dynamic process of

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\(^3\) Tirole, supra, note 47 at 76-8 ("Consider the rent associated with monopoly pricing...It is clear that the existence of this potential rent may lead to rent-seeking behaviour. Firms will tend to spend money and exert effort to acquire the monopoly position; once installed in that position they will tend to keep on spending money and exerting effort to maintain it"); J.A. Brander, Government Policy Toward Business (Toronto: Butterworths, 1992) at 49 ("rent seeking is the process of trying to obtain (or retain) economic benefits by having them redistributed from others rather than by creating new wealth").
competition and therefore desirable, we must also acknowledge that rent seeking behaviour will be an inherent outcome of a system which invites firms to pursue strategies which maximize their own profits. Dominance motivates both competition and rent seeking. It follows that any final conclusion about the desirability of dominance requires an evaluation of the total welfare effects of all market conduct motivated by the prospect of dominance.

Certainly, to the extent that a society relies upon competition as the primary method of maximizing its total welfare, it is evident that a regime of free enterprise alone is insufficient to ensure that the welfare promoting aspects of the process of competition are maintained. It appears that there is ample need for effective regulation to ensure that the process of competition, with its apparent ability to continually increase internal, allocative and dynamic efficiency, prevails in the market place, thereby maximizing total welfare. At the same time, such regulation must discourage rent seeking.

In the next chapter we examine in detail the welfare effects of dominance. However, before proceeding, the semantic breadth of the word "competition" evident in our discussion requires us to adopt the following terminology. As our definitions differ materially from much of the common usage of the terms defined, they should be especially noted.

**An Addendum - The Language of Competition**

We will use the term rivalry to refer to all activities undertaken by firms in the marketplace in the pursuit of profits. Such conduct may have positive, negative or neutral effects upon total welfare. Competition or competitive behaviour will be used to refer to the process or activity of innovation and imitation. We have already defined innovation as a change in a product, production process or demand created by a firm and imitation as the
activity of copying successful innovations by other firms. The term dominant firm or dominance will be used to refer to firms which enjoy a relative absence from the effects of competitive behaviour by other firms. When referring to the competitive structure of a market we will use the term concentration. Finally, we will use the term rent seeking to refer to the process or activity of preventing innovation or imitation.
Chapter 3: What are the Welfare Effects of Dominance?

In the previous chapter we reached an important conclusion. Rather than characterizing dominance as a state which arises when there is relatively less competition in the market place, we illustrated how the rise and fall of dominant firms, over time, is consistent with the dynamic of the process of competition. As a result instead of being viewed as the antithesis of competition, dominance is seen as an integral part of the competitive process. Dominance is the manifestation of competitive success within a system that invites rivals to strive to maximize profits. It is a logical outcome in a market system because markets are driven by the pursuit of profits. Therefore, when it comes to considering the welfare effects of dominance, we must understand dominance as a motive, rather than a static market structure. Dominance is an inherent part of the way the market system operates. The prospect of dominance, and its associated supra-normal profits motivates firms to act. The question is whether all actions motivated by the prospect of dominance are socially desirable or undesirable. In that context, our approach to the issue of regulation of the market conduct of dominant firms has been the adoption of the concept of maximum social benefit (expressed in terms of the total value of goods and

94 Compare J. Reinganum, "Innovation and Industry Evolution" (1985) 99 Q.J. of Econ. 81 where the author argues that an incumbent earning supra-normal profits has less desire to innovate. As a result there is innovation by successive entrants who become dominant for a time. A static picture taken at any time reveals a dominant firm market structure, but over time the identity of the monopolist is continually changing.

95 Often, this truth is expressed in negative terms. The Darwinian metaphor of survival of the fittest is used. However, competition is a struggle for success, not survival. Certainly, in the process some firms, affected in a negative way by the successful strategies of other firms, strive to survive as they are overtaken by competitors. However, the reason some firms have to strive to survive is because others are striving to win supra-normal profits, not vice versa. The dynamic within a market system originates in firms seeking additional profits. It is their activities which provide competitive pressures on other firms.
services produced) as the measure of utility of any particular law\textsuperscript{96}. Put shortly, the question we would ask in order to determine whether the market behaviour motivated by dominance is socially desirable or undesirable is "will it increase total welfare?\textsuperscript{97}.

In this chapter we will differentiate the types of market conduct which are motivated by the prospect of dominance and then consider whether they increase or decrease total welfare.

**Conduct Associated With Dominance**

It can be said that within a dynamic perspective of competition firms exist "in order to create and obtain economic rents and perhaps as well...[to] attempt to minimize the risks associated with their operations by minimizing competition and avoiding the marketplace"\textsuperscript{98}. As we have argued, dominance can be viewed as the manifestation of success in the rivalry between firms motivated by the pursuit of profits. In the market place there are just three ways that a firm may seek to secure a position which is relatively free from the effects of market behaviour by rivals or market dominance.

The first is to be a catalyst for change. The firm may take a leadership role investing in research and development, adopting new marketing and advertising techniques, exploring new approaches to business organization, or location of premises - doing things differently to rivals. When a firm discovers a new product, a new way of producing a

\textsuperscript{96} See above, c.2 - The Market System. We will consider some of the criticisms of an approach based exclusively upon the maximization of total welfare below in c.4 - The Equitable Distribution of Wealth and Power.

\textsuperscript{97} For a summary of the empirical research attempting to measure the welfare outcomes of the existence of market power see Hay & Morris, *supra*, note 4 at 581-9.

\textsuperscript{98} F. Lazar, "Monopolistic Competition - A Stable Market Structure" (Faculty of Law: University of Toronto, 1983) [unpublished] at 25.
product, or a new way of packaging and marketing a product, which is wanted by customers, it finds itself, for a time, relatively free from competitive constraint. To a degree it becomes a dominant firm able to earn supra-normal profits\textsuperscript{99}. It is the prospect of earning such profits that motivates the firm to be innovative, investing in new products, new methods of production and new ways to influence customers. Therefore, the first behaviour that may be adopted by a firm coincides with our earlier definition of innovation.

The second approach is to copy the successful changes made by others, or to continue to use those strategies which have been successful in the past. Such a strategy enables a firm to avoid the risk associated with investment in new ideas. Once a firm has established a new strategy in the market place that is successful, and is earning supra-normal profits (or even is showing the potential to do so) the strategy can be copied by others. A firm may be able to learn from the mistakes of the innovator and introduce the change more cheaply. Research shows that such follower strategies can be very profitable, enabling the imitator to share in the opportunity for supra-normal profits discovered by the innovator, albeit during a period when the level of such profits are declining due to the increase in competition\textsuperscript{100}. Such follower strategies coincide with our earlier definition of imitation.

The third approach involves changing the market so that there are less competitors affecting the business of the firm, or, as is more common, preventing changes in the market that would tend to increase the effect which competitors may have upon the business of the firm. Absent from such a strategy is any attempt to supply that which is demanded by

\textsuperscript{99} E. Mansfield, \textit{supra}, note 73 has shown that in the case of smaller firms successful innovation has a dramatic impact upon growth

\textsuperscript{100} Hay & Morris, \textit{supra}, note 4 at 480ff; and Tirole, \textit{supra}, note at 402ff.
customers, which is the essence of the strategies of innovation and imitation. In such an approach, relative freedom from competitive constraint, or market dominance, is created or protected by preventing rivals from supplying the same customers as the firm. That such entry deterring strategies are pursued by firms has been the subject of extensive analysis. They are profitable where the opportunity to earn supra-normal profits is worth more than the cost of ensuring that a rival is not able to compete for those profits. Such exclusionary strategies coincide with our earlier definition of rent seeking.

To summarize, firms may secure a position that is relatively free from competitive constraint by introducing a new idea that is desired by customers, copying a successful new idea introduced by another, or by preventing innovation or imitation by other firms that would make them competitors of the firm. The attractiveness of innovation or the difficulty of imitation also may be heightened by factors external to the market conduct of firms. However, the market conduct which is motivated by the prospect of achieving dominance is innovation, imitation and rent seeking.

Once dominance has been achieved there are two ways in which the activities of a dominant firm differ from those of a firm subject to competitive constraint. They were considered in detail in the previous chapter. Dominant firms engage in supra-normal pricing thereby extracting supra-normal profits, a practice that is allocatively inefficient. Further, dominance tends to lead to X inefficiency.

It is the interaction between these five behaviours - innovation, imitation, rent seeking, monopoly pricing and X inefficiency - that is the market conduct associated with dominance. Understanding the welfare effects of dominance requires a clear picture of how

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these behaviours are inter-related. We can begin by distinguishing between the first three behaviours and the second two. The first three - innovation, imitation and rent seeking - are expressions of the rivalry between firms. The second two - monopoly pricing and X inefficiency - result when a relative absence of rivalry between firms occurs. It is the first three behaviours that are the dynamic elements. The second two behaviours are outcomes, rather than a part of the dynamic. Therefore, in order to understand the welfare outcomes of rivalry we will focus upon innovation, imitation and rent seeking. In this chapter we will consider the welfare effects of each behaviour in turn. We acknowledge that this division is somewhat artificial as there is an inter-relationship between innovation, rent seeking and imitation. Therefore, in our discussion we will also address the inter-relationship. However, it is helpful to begin by thinking of rivalry in terms of these three categories of behaviour, each motivated by the prospect of dominance.

An evaluation of the change in total welfare resulting from each type of rivalrous behaviour involves an evaluation of the net effect upon three outcomes; dynamic efficiency (the value of any innovation - or loss of innovation); allocational efficiency (the combined effect of addition or elimination of rent seeking and deadweight loss); and internal efficiency (increase or decrease in X inefficiencies).

The Welfare Effects of Innovation

We argue that innovation will usually increase total welfare. Consider first whether the increase in dynamic efficiency resulting from the innovation is likely to be larger than any deadweight loss resulting from monopoly pricing by the innovative firm. The broad dynamic resulting from innovation is as follows. As one firm in a market obtains a
competitive advantage through innovation it will start to earn supra-normal profits. Competitors will lose sales to the firm with the advantage. Those competitors will be forced to imitate the successful strategy that gave the innovative firm an advantage (or better that advantage), or be forced out of business. In the latter case, the firm with the advantage will become a monopoly. However, provided it prices the product below the previous market price there will be an increase in total surplus measured against the historical base. Indeed the cost base of the former competitors will likely operate as a ceiling on any price increase by the innovating firm because at such prices it would be profitable for the former competitors to re-enter. The process of competition through innovation leads to a state of affairs where there is less competition, but the process itself increases total welfare.

A merger which results in efficiencies is one example of innovative behaviour that creates market power. Williamson has shown, and his basic intuition is generally accepted, that small cost efficiencies dominate much larger increases in market power in terms of qualitative importance. Indeed, where the market price after a merger is lower than the market price before the merger there has clearly been an increase in total

102 Such limit pricing, though evidence of market power, is to be preferred to monopoly pricing which maximizes supra-normal profits for the dominant firm.


104 A. Fisher & R. Lande, "Efficiency Considerations in Merger Enforcement" (1983) 71 Cal. L.R. 1580 at 1583 & 1624-51; Hay & Morris, supra, note 4 at 573-4; and Crampton, supra, note 88 at 100.

105 Williamson, Revisited, supra note 103 at 709 ("...a relatively modest cost reduction is sufficient to offset relatively large price increases even if the elasticity of demand is as high as 2, which for most commodities is probably a reasonable upper bound").
welfare. Of course, the difference between a merger and an innovation is that a merger may eliminate rivals and create barriers to future entry (or the potential for such barriers to be raised through strategic conduct by the merged entity). In the case of efficiency gains through innovation there is no necessarily negative impact upon competitive behaviour. Therefore, the argument is even stronger that the dynamic efficiencies will outweigh the allocative inefficiencies because the rivals remain to limit monopoly pricing and to compete away the competitive advantage of the innovator. Indeed if one considers that the limit price is likely to be the market price prior to the innovation, then the effects upon total welfare of the innovation are likely to be positive in most cases.

Of course, such an analysis is subject to the criticisms of Williamson's "naive" model. The first criticism has been that where the market was not competitive prior to the efficient change, then the effect of enhanced market power may outweigh the efficiency gains. However, such an analysis presumes that there was no welfare benefit created by the original relative absence in competition. If the original market structure resulted from innovation, then, measured from a competitive historical base, the welfare difference between the dynamic efficiency of the innovation and the allocative inefficiency of the market power will be positive. Further, any policy which promotes the process of competition will encourage imitation which, in turn, will have the effect of limiting the period of any relative absence of competition. We advocate laws which promote the cycle

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of innovation and imitation.

The second criticism concerns elasticities of demand. It has been argued that Williamson's analysis only holds where, at prices surrounding the market price prior to merger, demand is relatively elastic; that is to say where there remain other products to which buyers are likely to switch if the merged firm was to raise its prices. However, competition laws focus upon mergers that increase concentration in a market. By definition, where a merger leads to relative concentration in a market, demand for the merged firm's product will be relatively inelastic as there are no substitute products to which buyers may switch if prices are increased. So, it is argued, in material cases demand is likely to be relatively inelastic. However, such an analysis does not translate to market power that is the outcome of innovation rather than merger. Innovation is part of the dynamic nature of competition. It is only where there is attendant to the innovation some power to exclude imitation that demand for the innovative product will remain inelastic. The tide of entry, attracted by the supra-normal profits, will ensure that, in time, demand is relatively elastic. The result is that the dead-weight loss resulting from the innovation will diminish over time, whereas the welfare gains from the innovation will remain. Therefore, we argue that over time (and provided the dynamic process of competition is allowed to function) Williamson's naive model shows that the gains from

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109 Fisher & Lande, supra, note 104 at 1643.

110 Because the social returns from innovation are higher than the private returns (innovation has public good characteristics) there is often a public policy concern that there is under-investment in innovation; Jorde & Teece, supra, note 91 at 53. Even the welfare benefits that are evident in the success which the innovator has in marketing its new product (or cheaper product produced with a process innovation) are difficult to quantify; R. Brenner, "Market Power: Innovation and Anti-trust" in F.Mathewson, M. Trebilcock & M. Walker, The Law and Economics of Competition Policy (Vancouver: The Fraser Institute, 1990) 179 at 187-90.

innovation are likely to outweigh the deadweight loss created by the market power associated with the freedom from competition associated with innovation.

There is another respect, beyond the immediate benefit to buyers of the innovative product, in which innovation has a positive impact upon welfare which is difficult to express in quantitative terms. The benefits of the innovation are rarely limited to the productivity gains or improvement in the quality of consumption created by the innovator. There are often significant spill over effects which contribute to increases in total welfare as the innovative insight is developed and applied in other areas\textsuperscript{112}. Spill over effects are likely to be more significant where the market is competitive\textsuperscript{113}. In short, the benefits from innovation in a marketplace where there is dynamic competition, will outweigh the costs of deadweight loss.

Now, as discussed above, dominance will also bring rent seeking and X inefficiency. Let us consider the likely effects of such behaviour upon the equation. Importantly, both are internalized by the innovative firm. They directly affect profitability. Therefore, the innovating firm itself will provide a check upon welfare losses through exclusionary conduct and internal inefficiency. Further, as we propose a regulation which prohibits rent seeking practices designed to protect or entrench market power\textsuperscript{114}, the remaining concern becomes internal efficiency. As to X inefficiencies, to the extent that a firm with market power does not have the same intensive competitive pressure to control costs and invest in

\textsuperscript{112} These may be seen as tending to inhibit innovation; see Jorde & Teece, \textit{supra}, note 91 at 53. This is discussed below; see section in this chapter - The Welfare Links Between Innovation and Rent Seeking.


\textsuperscript{114} See c.6 below.
further innovation, the relative freedom from competition resulting from innovation may reduce total welfare\textsuperscript{115}. However, X inefficiency is generally associated with entrenched dominance and may be overcome by the use of the wasted resources in the production of output by the dominant firm - a result that could be achieved through strict cost control measures\textsuperscript{116}. Where innovation leads to a short term advantage which is soon overcome by imitators there is not the same likelihood of X inefficiency. It has also been argued that an efficient capital market operates as a constraint upon X inefficiency\textsuperscript{117}. Therefore, X inefficiency is not a necessary outcome of innovation.

Further, that which is perceived as increased costs may be more accurately characterized as the sharing of supra-normal profits between owners, managers and workers in the form of higher salaries and benefits\textsuperscript{118}. To the extent that managers and workers must be induced to develop supra-normal profit opportunities through innovation, such additional "costs" may be seen as an inherent part of the incentive necessary to drive the dynamic process of competition. To summarize in terms of our opening "equation", we conclude that where rivalry is manifested as innovation, the welfare value of the innovation will generally be greater than the dead weight loss flowing from the resultant monopoly pricing based upon three factors - the Williamson model, the tendency of the process of competition to reduce deadweight loss over time through imitation and the spill over effects

\textsuperscript{115} Leibenstein, supra, note 59 c.3; and Dunlop, McQueen & Trebilcock, supra, note 8 at 160-4.


\textsuperscript{117} Dunlop, McQueen & Trebilcock, supra, note 8 at 181ff review the literature on this issue. There is support both for and against the view that a merger and acquisition market promotes internal efficiency amongst prospective targets.

\textsuperscript{118} R. Parish & Y. Ng, "Monopoly, X-Efficiency and the Measurement of Welfare Loss" (1972) 39 Economica 301.
of innovation. Although rent seeking may well be greater than this net gain, we propose that rent seeking be kept to a minimum through laws prohibiting such behaviour. Finally, the functional links between X inefficiency and the existence of market power are not direct and, again, are less likely to be evident in a dynamically competitive environment. Therefore, in broad terms, total welfare may be seen as being positively affected by innovation.

The Welfare Effects of Rent Seeking

Now consider the case where rivalry is expressed as rent seeking behaviour instead of innovation. As foreshadowed above, we contend that rent seeking will have a negative effect upon competition. Using slightly different terminology to that which we have adopted, Posner\textsuperscript{119} has articulated the cost to society of rent seeking behaviour designed to protect supra-normal profits in the following way

\begin{quote}
The existence of an opportunity to obtain monopoly profits will attract resources into efforts to obtain [and, by analogy, sustain] monopolies, and the opportunity costs of those resources are social costs of monopoly too\textsuperscript{120} (parenthesis added).
\end{quote}

Although in the case of rent seeking behaviour the factors that combine to affect total welfare are the same, their interaction is materially different\textsuperscript{121}. The functional links in the equation are not inverse.


\textsuperscript{120} Posner, \textit{ibid.} at 807. Stigler, \textit{supra}, note 47 at 23-8 develops similar ideas in respect of non-price competition among members of a cartel.

\textsuperscript{121} So empirical studies which focus upon the outcome of supra-normal profits without identifying their cause do not accurately measure the social cost of dominance; Hay & Morris, \textit{supra}, note 4 at 584-5.
With respect to innovation, it is important to differentiate two issues - bigness and dominance. As to bigness, although the risk, scope and cost of innovation may favour larger enterprises, there is a bias away from imaginative new ideas in large organizations due to the personal risk to managers who may be associated with a failure and the bureaucratic burdens of over-organization. A survey of the literature leads to the conclusion that

No single firm is uniquely conducive to technological progress. There is room for firms of all sizes. What we want, therefore, may be a diversity of sizes, each with its own special advantages and disadvantages.

As to dominance, the argument must be that because dominant firms are more innovative, rent seeking, which protects and entrenches dominance, thereby encourages innovation. Although Schumpeter argued that relative monopoly was necessary before there would be investment in innovation, research has shown that the competitive structure of markets has little impact upon innovation. Monopoly is not a precondition to innovative behaviour. Rather, from a dynamic perspective, dominance is the outcome of innovation. It is a reward that encourages innovation. Any argument that rent seeking

\[ \text{122 Scherer, supra, note 4 at 414.} \]

\[ \text{123 Ibid. at 418.} \]

\[ \text{124 Schumpeter, supra, note 68 at 101.} \]

\[ \text{125 See W.M. Cohen & R.C. Levin, "Empirical Studies of Innovation and Market Structure" in R. Schmalensee & R. Willig, eds., Handbook of Industrial Organization vol. 2 (Amsterdam: North Holland, 1989); and J.F. Brodley, "The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress" (1987) N.Y.U.L.R. 1020 at ("there is increasing evidence that small firms are the most fertile source of innovation. Since small firms are also the most likely victims of exclusionary practices, the costs of an underinclusive rule are likely to be higher than previously thought, making the tradeoff in favour of vigorous enforcement more clearly beneficial to social welfare").} \]

\[ \text{126 There has been some research which adopts a dynamic perspective to the question of the connection between dominance and inventiveness. Such studies conclude that concentration is the outcome of innovation; e.g. R.N. Nelson & S.G. Winter, "Forces Generating and Limiting Competition under} \]
behaviour leads to increases in total welfare through innovation is dependent upon a link between existing dominance and innovation.

Are dominant firms greater innovators? There is a proliferation of evidence which, properly reviewed, "does not support the hypothesis that market structure (concentration) and firm size are significant determinants" of investment in innovation once asymmetries in technological opportunity are taken into account. Indeed, there is evidence that entrenched monopoly reduces the incentive to innovate in that there is a tendency for the monopolist to settle for a comfortable lifestyle rather than the riskier path of pursuing further profits through innovation. There is not the same profit incentive for a monopolist to innovate as there is for the firm faced with strong competition restricting its ability to earn supra-normal profits. Thus, although rent seeking practices are functionally linked to the level of successful innovation, innovation is not increased by the level of successful rent seeking practices.

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Schumpeterian Competition" (1978) 9 Bell J. of Econ. 524.

127 Hay & Morris, supra, note 4 at 489, following extensive review 473ff; and Scherer, supra, note 4 at 423-38.

128 It is a tendency summarized in the oft quoted statement of J.R. Hicks, "Annual Survey of Economic Theory: The Theory of Monopoly" (1935) Econometrica 1 at 8, "The best of all monopoly profits is a quiet life".

129 Leibenstein, supra, note 59; Shepherd, supra, note 4 at 146-7 and Scherer, supra, note 4 at 414. Further, a dominant firm has less incentive to invest in an innovation that will simply replace its existing market power; K. Arrow, "Economic Welfare and the Allocation of Resources for Inventions" in R. Nelson, ed., The Rate and Direction of Investment Activity (Princeton University Press, 1962). It is the threat of competitive entry that motivates a dominant firm to invest in innovation; Tirole, supra, note 47 at 392-3. Rent-seeking practices exclude competitive entry.

130 Successful innovation being that which creates the opportunity to earn supra-normal profits and supra-normal profits being that which justifies rent-seeking expenditures.

131 Successful rent seeking practices being those that protect existing market power. The case where rent seeking practices are necessary to create a barrier to imitation in order to encourage innovation is considered below - The Welfare Links Between Innovation and Rent Seeking.
Also, rent seeking practices have a different effect upon dead weight loss to innovation. Absent any barrier to imitation that exists independent of the conduct of the firm with market power, rent seeking practices will stem the tide of innovation that would usually be attracted to any opportunity to earn supra-normal profits. Whereas innovation tends to attract investment that will itself reduce, over time, the deadweight loss resulting from a successful innovation, rent seeking practices entrench (and may increase) the allocational inefficiency caused by the exercise of market power.

Therefore, we conclude that the effect of rent seeking upon total welfare will be negative\textsuperscript{132}.

**The Welfare Effects of Imitation**

In order to complete our analysis we need to consider the welfare effects of imitation. They may be shortly stated. The process of imitation, encouraged by the opportunity to earn supra-normal profits created by the innovator reduces deadweight loss and X inefficiency. The entry of imitators moves the market towards allocational and internal efficiency. Although, imitation does not generate innovation directly, it does so indirectly because the fact that firms faced with direct competition become limited by existing technology to earning normal profits, encourages firms to be innovative and restart the cycle of innovation and competition\textsuperscript{133}. Therefore, the welfare outcomes of imitation

\textsuperscript{132} We do so subject to our discussion of the welfare links between innovation and exclusion below - The Welfare Links Between Innovation and Rent Seeking.

\textsuperscript{133} Scherer, * supra*, note 4 at 437-8 states "There is abundant evidence from case studies to support the view that actual and potential new entrants play a crucial role in stimulating technical progress, both as direct sources of innovation and as spurs to existing industry members". However, some would argue that too much competition stifles innovation in that there are no surplus funds for investment in new technology (a view that originated with Schumpeter, * supra*, note 68).
are positive - and more so if they are seen as part of the dynamic process of competition.

The Welfare Links Between Innovation and Rent Seeking

To this point we have almost invariably expressed the process of competition in sequential terms - innovation followed by imitation. However, the investment of a firm in innovation will be materially affected by the firm's perception of the length of the period before imitation will compete away the opportunity to earn supra-normal profits created by the invention. Before investing in innovation, a firm will appraise the prospect of competition in the future. An assessment will be made of how quickly the invention may be expected to diffuse through the market place so that it becomes part of the technological base available to all rivals in the marketplace. Without a lag between imitation and innovation, there is little incentive to innovate. Indeed, in such cases, there may be considerable advantages in waiting to imitate the innovations of others.

Many of the factors that contribute to the delay in imitation will exist independently of any exclusionary conduct by the firm. They may be the incidental outcome of competitive behaviour. For example, the complexity of the innovation and the time required to imitate, the time required to train employees, investment in significant

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134 The term "diffusion" is often used in the literature to describe the period of lag between innovation and imitation; e.g. W.E.G. Salter, Productivity and Technical Change 2nd ed., (Cambridge, 1966) & S. Davies, The Diffusion of Process Innovations (Cambridge, 1979).

135 For a discussion of such strategies see Hay & Morris, supra, note 4 c.13.

136 Firms learn from mistakes. The way such experience may deter entry is expressed in the phenomena of the learning curve "the more one produces of something such as an innovative item just coming into mass production, the more one lowers costly mistakes and quality-control rejections - and therefore, the more one lowers average unit cost. A new entrant must not only be aware of the technology, but also the experience in its application in order to be able to compete successfully.
plant capacity in order to meet expected future demand\textsuperscript{137}, advertising\textsuperscript{138}, release of new products\textsuperscript{139}, or vertical integration to ensure availability of inputs and channels of distribution for the innovated product\textsuperscript{140}. In other cases they may be influenced by the market behaviour of the firm in taking advantage of exclusive property rights recognized by the law. So imitation may be delayed by the exclusive right to a brand or trade mark, existing market reputation, trade secrets, fiduciary obligations of employees, patents or a well known business location. Still others may be the outcome of factors independent of the market behaviour of the firm, such as government regulation, or geographical barriers. All such factors combine to delay imitation significantly beyond the immediate and timeless response that would be associated with the model of perfect competition. We describe factors that create a lag between innovation and imitation as barriers to diffusion. Importantly, they are an incidental outcome of the process of competition within the existing property law structure, rather than the result of any strategic investment in exclusionary behaviour by the firm.

To a significant degree, barriers to diffusion may be seen to be sufficient to encourage investment in innovation. Of course, there is no precise correlation between the height of barriers to diffusion and the delay in innovation that is necessary to encourage a

\begin{itemize}
\item\textsuperscript{137} In doing so it may make entry more difficult for prospective entrants; Lieberman, M., "Excess Capacity as a Barrier to Entry: An Empirical Appraisal" (1987) 35 J. of Ind. Econ. 607.
\item\textsuperscript{138} Advertising may operate as a sunk cost that deters entry; see the summary of the literature in Hay & Morris, supra, note 4 at 227-8.
\item\textsuperscript{139} The use of "fighting brands" is expressly referred to in s.78 of the Competition Act; see Eddy Match Co. Ltd v. The Queen (1953) 20 C.P.R. 107. The use of numerous brands as an exclusionary tactic, inconsistent with normal competition, was argued in Re Kellogg Co 99 F.T.C. 8 (1982).
\item\textsuperscript{140} Such conduct would have the incidental effect of requiring competitive entry at a number of functional levels in the market simultaneously - which would be logistically more difficult as it would accentuate the difficulties at each level by combining them all.
\end{itemize}
particular innovation. In theory, the barriers to diffusion should be kept to the minimum necessary to encourage innovation. Indeed, Shepherd has argued that

[t]he social aim is to obtain the benefits of the good actions, while minimizing the social costs that are imposed by the monopoly rewards. Therefore, the efficient reward for the dominant firm should be identified and the actual reward should not go above that level.

Because the benefits are finite, the efficient reward will always be finite in amount, rather than unlimited. Therefore an open-capture basis for rewards can be immediately rejected. It has no place in an efficient economy, operating in line with neoclassical economic theory. There, all factors are paid finite amounts, related to the value of their contributions to production. Only a finite reward to dominant firms is consistent with that efficient system\textsuperscript{141}.

The difficulty with such an approach is that, despite the author's assurance that it can guide the broad thrust of policy, it assumes that the value of an innovation can be measured with some precision. Such an approach would require that there be a limit upon profits that may accrue to a firm from an innovation (even without exclusionary behaviour). It would also, presumably, condone exclusionary behaviour where it was necessary to create enough protection from subsequent imitation to induce a firm to innovate. Rather than the dichotomy between competitive behaviour and rent seeking behaviour that we have articulated, Shepherd would regulate on the basis of the minimum profit incentive necessary to encourage an innovation.

There are a number of practical difficulties with such an approach. First, the diversity of returns that may be generated from innovations is extreme and dependent upon the factual circumstances of each case. The result is that it is not possible to formulate a

rule of general application. Second, by its nature innovation is an uncertain and risky business. The specific returns that are needed in order to encourage a particular investment are usually only apparent after the fact\textsuperscript{142}. Third, reducing the returns from an innovation to the margin may well undermine the incentive that drives the process of competition. Why invent if all that is going to be earned is the same level of profits that would be earned without inventing? Fourth, it is difficult to see how Shepherd’s approach could be implemented without substantial bureaucratic intervention which has its own cost. A rule which allowed exclusionary behaviour would have to be qualified in terms which limited such behaviour to the degree necessary to encourage innovation. Such a rule would be difficult to supervise due to its dependence upon a detailed assessment of the facts in each case.

However, Shepherd’s analysis does expose one deficiency in our characterization of rent seeking practices as necessarily welfare reducing. We have not addressed the question whether, in cases where the barriers to diffusion within the economy are insufficient to encourage investment in a particular innovation, rent seeking practices ought be allowed in order to encourage the innovation. The question is whether allowing exclusionary practices in addition to the barriers to diffusion inherent in the existing marketplace will increase total welfare. We argue, for the reasons which follow, that where barriers to diffusion are insufficient to encourage welfare improving innovations, regulations other than competition laws are the most efficient means of improving total welfare.

First, in overall terms, the welfare losses associated with unrestricted rent seeking are likely to be greater than the welfare gains through innovation stimulated by such an

\textsuperscript{142} Nordhaus, \textit{supra}, note 70 at 55.
approach\textsuperscript{143}. Though not without criticism, studies which have attempted to calculate the loss from rent seeking associated with monopoly have shown it to be a dramatically larger concern than the allocative inefficiency resulting from supra-normal pricing\textsuperscript{144}. Rent seeking is the means by which dominance may be entrenched. It is open ended. There is no way that exclusionary conduct that encourages innovation can be differentiated in character from exclusionary conduct that simply leads to entrenched profits far exceeding that which was necessary to induce the investment in developing the innovation.

Second, in the context of a consideration of the welfare value of the patent system (a legalized form of exclusionary conduct in which firms may invest) Scherer argues, after reviewing the research, that barriers to diffusion are already widespread in an industrialized economy and operate as a substantial incentive for innovation in most cases.

We find that business firms may invest in innovation without patent protection if natural imitation lags are substantial, if there are major competitive differentiation advantages from being first in the market with a new product, and/or if the market is oligopolistic. All three characteristics are widespread in a modern industrialized economy...It is only when the barriers to widespread and rapid imitation are weak, or when the advantages of competitive leadership are modest, or when the profit potential of the innovation is small, or when there is some adverse combination of the three, that patent protection becomes an important incremental stimulus\textsuperscript{145}.

By analogy, the same reasoning refutes the argument that rent seeking practices ought be

\textsuperscript{143} Shepherd, supra, note 141 at 127 and authorities cited therein.

\textsuperscript{144} See K. Cowling & D.C. Mueller, "The Social Costs of Monopoly Power" (1978) 88 Econ. J. 727 (for criticisms of their study, see Hay & Morris, supra, note 4 at 584-5).

\textsuperscript{145} Scherer, supra, note 4 at 447.
allowed because they encourage innovation\textsuperscript{146}.

Third, and more important, is Scherer's conclusion that the benefits of the patent system are probably confined to two categories of innovation - "those whose economic value is modest in relation to development costs, and those that represent unusually bold, risky departures from known technology"\textsuperscript{147}. Only the second category is of considerable welfare significance. In such cases, other policy interventions which encourage investment in riskier innovations such as taxation incentives, government research programmes, research grants and subsidies and special patent protection are to be preferred to the enactment of a competition law which allows exclusionary behaviour (with its attendant welfare loss) in all cases\textsuperscript{148}.

Fourth, the more significant the welfare effects of an innovation, the lower the barriers to diffusion required to recoup the investment in the innovation - and therefore to encourage private investment in the innovation. Such innovations require only a short period in which to recoup their cost their large benefits bring substantial opportunities for supra-normal profits\textsuperscript{149}.

Fifth, to accommodate a rule which prohibited exclusionary behaviour only in cases where it resulted in a net welfare loss taking into account the effects upon dynamic efficiency would create substantial administrative costs.

Sixth, there is significant support for the view that there are greater incentives for

\textsuperscript{146} There have been variable outcomes from empirical research concerning the rate of diffusion of innovations in the marketplace. However, such studies fail to differentiate between "barriers to diffusion" and "exclusionary behaviour"; Salter, supra, note 134.

\textsuperscript{147} Scherer, supra, note 4 at 454.

\textsuperscript{148} Hay & Morris, supra, note 4 at 660; Scherer, supra, note 4 at 457-8.

\textsuperscript{149} Nordhaus, supra, note 70 at 76-82.
firms that are subject to competitive pressure to innovate, than for entrenched dominant firms. Rent seeking practices, in creating barriers to competition, directly reduce the incentive for dominant firms to innovate.

**An Aside Concerning Significant Exogenous Barriers to Diffusion**

There remains a further issue raised by the fact that the dynamic of the marketplace includes the possibility that there may be barriers to diffusion independent of the market behaviour of the firm. In some cases, factors exogenous to the conduct of a firm may play a significant role in the dynamic. Competition will be deterred by such factors. For example, the innovative behaviour of a firm which results in the position of dominance may comprise obtaining the only government licence to supply a particular product, or the establishment of its business in a superior geographical location for which there is no physical alternative, or supplying a market in which the level of demand results in one firm being the only efficient scale to supply the product. In such cases, the context in which the innovative firm changes its market behaviour makes it inherently difficult for other firms to imitate the strategy. These factors prevent imitation as effectively as rent seeking behaviour, but, importantly, they are not part of the conduct of the dominant firm. At best such factors provide a motive for certain innovative behaviour by firms. Their existence means that firms may be expected to invest in change which will secure a position that is likely to be relatively free from competitive constraint due to factors external to the conduct of the firm which will prevent imitation. In other words the competitive conduct of firms may be expected to exploit opportunities created by exogenous barriers to diffusion.

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150 See the summary by Shepherd, *supra*, note 4 at 146-7.
Often no distinction is drawn between the dynamic created by such exogenous barriers to imitation, on the one hand, and the opportunities to exclude competitive conduct through rent seeking barriers to imitation, on the other\textsuperscript{151}. However, we wish to emphasize the distinction as it is a significant one in the context of our concern to identify with precision the socially undesirable market conduct of dominant firms. In such a context it is important to focus upon the conduct of the firm, not exogenous barriers to diffusion. Recognizing that exogenous barriers exist is a necessary part of understanding the dynamic of market conduct that results from the prospect of dominance. However, such barriers are external to the conduct of the firm.

An example assists in understanding the distinction. Assume that the government grants a single television licence for a particular region. Firms will compete for the licence investing in innovative and imitative strategies in order to secure it. Firms may also engage in rent seeking behaviour to prevent or persuade other firms from competing for the licence. The outcome of all such conduct will be the grant of the licence to a particular firm. That firm will be dominant in the region in which the licence operates. The fact that a licence is required to compete with the firm will operate as an absolute barrier preventing new firms from adopting innovative or imitative strategies in order to secure a share of the supra-normal profits enjoyed by the licence holder. However, no conduct by the incumbent

\textsuperscript{151} Bain, supra, note 47 at 255ff makes no distinction between the source of the barrier. Any condition of entry "that permits established firms to elevate price at least somewhat above minimal average costs without inducing new firms to enter obviously reflects the existence of some barrier to entry" (emphasis added). Stigler, supra, note 47 at 67ff approached the issue in a slightly different way defining barriers to entry as "a cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry". Stigler intended to exclude those barriers which are merely the expression of past successful strategies; \textit{ibid.} 67-8. This comes closer to our distinction, but still characterizes barriers as external to the firm whereas we distinguish barriers which are the outcome of conduct (either competitive or rent seeking) and barriers which are the outcome of external considerations or context (e.g., location, market size relative to scale efficiencies or a system of government licensing).
creates or sustains that barrier. Certainly the licence holder may be expected to engage in supra-competitive pricing and to operate with X inefficiency. But that conduct is an expression of dominance, it is not the conduct that creates or sustains dominance. In such cases, the conduct that creates or secures the position of dominance will still be either competitive or rent seeking behaviour.

Nevertheless, our analysis of the social desirability of dominance was dependent upon the prospect that investment in innovation and imitation would be attracted by the opportunity to earn supra-normal profits thereby ensuring the overall benefits of the dynamic of the process of competition. In cases where the barriers to diffusion independent of the market behaviour of the dominant firm make the position of dominance relatively unassailable, there is a strong argument for some regulatory intervention to replace the discipline that would, in the absence of such exogenous barriers, be provided by the dynamic of the process of competition. However, there are substantial difficulties in formulating a conduct based rule to deal with such cases.

In the United States the courts have attempted to develop a rule. It is known as "essential facility doctrine" or "bottleneck theory". In various decisions the District Courts in the United States have described conduct as monopolization where there is control of an essential facility and no reasonable prospect of competition in the supply of

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152 Although the rule has not been developed in the context of exogenous barriers to diffusion, we will endeavour to show that it is an attempt to deal with those cases where such barriers are the predominant factor influencing the conduct of the dominant firm.

the facility. Though the reasoning has been diverse\textsuperscript{154}, four principles expressing its key elements have received approval in a number of cases\textsuperscript{155}. They are as follows

1. Control of the essential facility by a monopolist;
2. The competitor's inability practically or reasonably to duplicate the essential facility to a competitor;
3. The denial of the use of the essential facility to a competitor; and
4. The feasibility of providing the facility\textsuperscript{156}.

The key element in the context of our current discussion is the second principle - inability to duplicate. The factual contexts in which the doctrine has been argued reveal that it is applied where there are barriers to entry which are not supported by ongoing conduct of the dominant firm, and which cannot be overcome by competitive behaviour. Examples include, the unique geographical location of a crossing point on the Mississippi River\textsuperscript{157}, access to a unique sports stadium\textsuperscript{158}; and control of telephone distribution networks\textsuperscript{159}.

We suggest that the underlying intuition that has led to the development of the doctrine is the recognition that in certain cases external factors prevent firms from competing for the supra-normal profits of a dominant firm, even when the dominant firm

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{154} Ratner, \textit{ibid.} at 328 ("Various circuit decisions have addressed the theory directly with differing tests, analyses and results").
\item \textsuperscript{155} Originally stated in \textit{Hecht v. Pro-Football Inc.} 570 F.2d 982 (1977) (D.C. Cir) [hereinafter \textit{Hecht}]; the four requirements for the application of the doctrine were summarized in \textit{M.C.I. Communications Corp. v. American Telephone and Telegraph Co.} 708 F.2d 1081 (19830 (7th Cir) [hereinafter \textit{M.C.I. Communications}] at 1133 and have been followed in \textit{Flip Side Productions Inc. v. Jam Productions Ltd.} 843 F.2d 1024 (1988) (7th Cir) at 1033, \textit{Ferguson v. Greater Pocatello Chamber of Commerce Inc} 848 F.2d 976 (1988) (9th Cir) at 983 and \textit{McKenzie v. Mercy Hospital of Independence} 854 F.2d 365 (1988) (10th Cir) at 369.
\item \textsuperscript{156} \textit{M.C.I. Communications}, \textit{ibid.} at 1133.
\item \textsuperscript{157} \textit{United States v. Terminal Railroad Association} 224 U.S. 383 (1912).
\item \textsuperscript{158} \textit{Hecht}, \textit{supra}, note 155.
\item \textsuperscript{159} \textit{M.C.I. Communications}, \textit{supra}, note 155.
\end{itemize}
\end{footnotesize}
is relatively passive, save for restricting supply of its commodity. Such a firm will act to restrict supply and thereby command a supra-normal profit, but such action does not have an impact upon competition. It is not exclusionary. It is not the conduct of the firm that is preventing the forces of competition from eroding the position of dominance - it is simply the context. The context may be a unique physical location or a scale efficiency that does not warrant a new entrant or a government licence that prevents new entry. The firm need not act to protect its monopoly by rent seeking practices because the factors external to the firm - its unique market context - mean that it can rely upon exogenous barriers to diffusion to protect its position.

In such cases the regulatory issue is not the prevention of conduct which is anticompetitive or an abuse of dominance - conduct designed to exclude competition rather than compete\textsuperscript{160} - rather it is the prevention of the practice of supra-competitive pricing. For such a firm, dominance is more than a transitory phenomenon. To promote competitive behaviour will not eliminate the inefficiency. The firm the subject of complaint is succeeding because of competitive strategies. What is necessary is to eliminate the external barrier or to prevent the restriction of supply attendant to supra-competitive pricing. It is no small coincidence that cases concerning the application of the essential facility doctrine usually concern an application for an order requiring supply "on competitive terms"\textsuperscript{161}.

Clearly, in the long-run, the promotion of total welfare requires some basis for

\textsuperscript{160} An important aspect of the cases decided under the essential facilities doctrine is that they concern the activities of lawful monopolists - those that have acquired their monopoly position through "skill, foresight and industry" or which are natural monopolists. The cases articulate the circumstances in which such lawful monopolists will have a duty to deal; see Troy, supra, note 153 at 442-6.

\textsuperscript{161} E.g., see the cases listed supra, note 155.
regulating the continuous practice of supra-competitive pricing, but only by firms operating in markets that are protected by exogenous barriers to diffusion\textsuperscript{162}. However, the nature of the issue suggests an administrative or supervisory regulation, rather than a conduct based regulation. The determination of a "competitive price", the calculation of a fair supra-normal return where there has been innovative investment in a risky venture which has, in the result, secured a protected stream of supra-normal profits and the difficulty in identifying when the facility is legitimately required by the owner for its own purposes require case by case decisions. In Australia and New Zealand such concerns have led to the rejection of the essential facilities doctrine\textsuperscript{163}.

As we are unable to regulate any unique conduct by firms protected by external barriers to diffusion, the regulatory alternatives are to supervise the pricing practices of the dominant firm; or to require the dominant firm to supply its product at a "competitive" price to all who wish to purchase it, thereby preventing it from restricting output and raising

\textsuperscript{162} It is important at this point to recall our earlier analysis that supra-competitive pricing, per se, is not socially undesirable. It is part of the means by which the dynamic of the process of competition operates. What our present discussion identifies is that in limited cases, where the ability to earn supra-normal profits is facilitated by factors external to the conduct of the firm, there is support for regulations proscribing supra-normal pricing. Part of the confusion attendant to the essential facilities doctrine has arisen because of an emphasis upon the definition of the power to monopolize (often described as monopoly power) as the ability to raise price or exclude competition. However, our analysis shows that the exercise of such monopoly power does not determine whether conduct is socially desirable. It may be the outcome of competitive behaviour (in which case it should be encouraged), or rent seeking (in which case it should be discouraged); see the detailed discussion of these issues below; c.5 - Monopoly Power. In the present context we must resist any tendency to equate the power to price supra-competitively (which follows form the exclusion of competition by any means) as necessarily being the outcome of socially undesirable market activity. It is the context, not the conduct, that is the concern in cases involving the essential facilities doctrine; compare Troy, supra, note 153 at 459-62.

\textsuperscript{163} See, in Australia, the decision of the Full Court of the Federal Court in Queensland Wire, supra, note 23 and, in New Zealand, the decision of the High Court in Union Shipping, supra, note 30, at 704-5. However, compare Auckland Regional Authority v. Mutual Rental Cars (Auckland Airport) Ltd. [1987] 2 N.Z.L.R. 647 at 679ff. in which Barker J. applied Hecht, supra, note 155. The case concerned a classic example of exogenous barriers to diffusion. The Auckland Regional Authority was a statutory body with exclusive statutory power to grant rights to car rental companies to operate from the Auckland Airport.

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price to supra-competitive levels\textsuperscript{164}. The very different regulatory issues raised by such alternatives compared to the issue of precise articulation of the dichotomy between normal competitive conduct and socially undesirable market conduct the subject of this paper cause us to exclude any attempt to provide for such factual situations in our analysis. Rather we contend that the problems of exogenous barriers to diffusion must be addressed by means other than a competition law which seeks to proscribe, as precisely as possible, market conduct associated with dominance that is socially undesirable irrespective of context.

To summarize, where there are substantial exogenous barriers to diffusion, the dynamic of the process of competition is interrupted. There is no change that can be made to attack the incumbent dominant firm. In such cases regulation requires the facilitation of change. Just as patent laws deal with the problem of insufficient barriers to diffusion, price control deals with the problem of insurmountable barriers to diffusion. However, in both cases the issue involves regulating the context, not the conduct, of market conduct by firms. It is impossible to proscribe investment in markets which are protected by exogenous barriers to diffusion. It would undermine the dynamic of the process of competition to proscribe the practice of supra-competitive pricing. Competition laws, concerned as they are with market conduct that is socially undesirable in most cases, are not the appropriate regulatory instrument to deal with the issue.

**Summary of Welfare Links Between Innovation, Rent Seeking and Exogenous Barriers to Diffusion**

We conclude that the role of exclusionary behaviour in creating barriers to diffusion

\textsuperscript{164} Compare the discussions by G.J. Werden, "The Law and Economics of the Essential Facility Doctrine" (1987) 32 St. Louis U.L.J. 433 at 474ff; and Troy, supra, note 153 at 483-6.
necessary to encourage innovation is not substantial; the welfare costs of allowing all rent seeking behaviour would outweigh the benefits that would flow from increased innovation through allowing firms to engage in exclusionary practices to raise barriers to diffusion; and to the extent that existing barriers to diffusion may be too low to encourage some welfare improving innovations, or too high to enable welfare improving imitation, policy tools other than competition laws will be a more effective means of redressing the concern.

Conclusion Concerning Welfare Effects Associated with Dominance

In summary we make three conclusions as to the welfare effects of market behaviour associated with dominance. First, innovative behaviour will be welfare improving. Second, to the extent that innovative behaviour establishes inefficiency, imitation after innovation will further improve welfare. Third, rent seeking, in preventing imitation will be welfare reducing unless it is undertaken to encourage an innovation with substantial welfare benefits. Where the process of imitation will be so rapid that it will discourage innovation entirely, complementary regulations that protect, for a time, the supra-normal profits that are required to attract innovation are justified. Patent laws and taxation incentives that reduce the cost of innovation fall into this category of regulation. Such laws may be considered to be a part of the barriers to diffusion necessary to encourage innovation. Where the process of innovation and imitation will be discouraged by exogenous barriers to diffusion, complementary regulations that control pricing or supply practices, or that facilitate competition are required. Such laws may be considered a necessary part of facilitating the process of competition.
Whose Perspective of Welfare?

One of the issues which an emphasis upon dynamic efficiency raises is whether innovative change actually brings increases in total welfare, even if demanded by consumers. As Areeda has put it, in somewhat biased terms "puritan commentators see not the virtue of greater perceived value but the vice of misled sheep"\(^{165}\). If a new product actually performs identical functions to, and is not materially different from, existing products which are supplied by a highly competitive industry at prices approaching the equilibrium that would arise in a perfectly competitive market, but is seen as more fashionable and therefore desirable than existing market offerings, thereby producing market power for the seller of the new product, is total welfare actually increased by the change? There are three issues raised by such a question.

The first concerns informational market failure. As we have seen from the assumptions underlying the models of perfect competition, it is necessary for buyers and sellers to have symmetric information concerning the commodity being offered for sale. In many cases a buyer may be persuaded to overvalue a product simply because she or he is unaware that there is an equivalent product available from another seller. An important element of the process of competition are laws and practices in the marketplace which encourage honesty and discourage misrepresentation. Most legal systems have laws that deal with such issues. In a number of jurisdictions "consumer protection" laws have been enacted as complements to competition laws\(^{166}\). However, such concerns transcend


\(^{166}\) E.g., ss. 52-59 of the Competition Act and ss.51A to 75A of the Trade Practices Act.
dominance and relate to the regulation of the marketplace generally. They need not be addressed in a law concerned with socially undesirable market conduct associated with dominance.

Nevertheless, it is important to recognize that the existence of informational asymmetries in the marketplace may be exploited by dominant firms. For example, the first firm to introduce a new product in the marketplace often achieves a reputation associated with its product of reliability, durability or established parts and after-sales service. The reputation itself may be the incidental outcome of competitive behaviour. However, it may be strategically exploited to prevent the entry of imitators into the market. The difficult task of distinguishing between competitive and exclusionary behaviour in such contexts is considered in detail below\textsuperscript{167}.

The second welfare issue concerns the extent to which a society is prepared to value consumer sovereignty. In one sense it may be more efficient for identical products to be produced instead of the proliferation of brands and product differentiation that is encouraged through the process of competition as firms strive to achieve a degree of freedom from competition. However, to regulate the proliferation of brands involves the making of value judgements as to whether the existing or proposed product differences by some mechanism other than the market. The cost of a bureaucratic mechanism make it unlikely that it will increase efficiency. Clark summarizes the role of consumer choice in the market mechanism in the following way

\begin{quote}

The process of consumer choice is necessarily a decidedly imperfect mechanism for selecting those producers who best serve the consumers’ interests; nevertheless it is a good deal
\end{quote}

\textsuperscript{167} See below, c.6.
more effective than might be thought, from an analysis that focuses upon its weakest links. To sum up, the consumer needs protection against his own mistakes, where health and safety are threatened... There is room for prohibition of some products..., for minimum standards of health and safety, for requirements that labels disclose content, where that is essential to consumer judgment\textsuperscript{168}.

However, wholesale rejection of consumer sovereignty in which individuals signal to the market what they want is to reject the market system as an efficient allocator of resources\textsuperscript{169}.

The third welfare issue arises due to externalities and public goods. There are some welfare consequences for society that are not factored into the equation when a transaction is made between a buyer and a seller. These welfare outcomes may be significant, but are not taken into account by a market system. To some extent buyers and sellers may be forced to take them into account through regulations which make them part of the market system\textsuperscript{170}. However, as important as it is to recognize that the welfare outcomes of a market transaction go beyond the effects upon individual buyers and sellers, such issues may be addressed by other policy interventions\textsuperscript{171}. They are issues that are not unique to dominant firms.

\textsuperscript{168} Supra, note 36 at 242.

\textsuperscript{169} See above, c.2. For an interesting discussion of the "consumer as limited sovereign" in the context of markets in which there is product differentiation; see Clark, supra, note 36 at 230ff.

\textsuperscript{170} For example, through regulations which impose a cost upon polluters; see Brander, supra, note 93 at 282ff.

The Regulatory Issue

Therefore, the specific welfare concern raised by the existence of dominance is the fact that it is an outcome that encourages rent seeking. Our analysis suggests that rent seeking conduct by all firms ought to be the focus of regulation.

However, two questions remain before we may conclude that existing dominance laws should be replaced by a regulation which proscribes rent seeking by all firms. First, is there any other socially undesirable outcome of dominance that is addressed by the existing laws? Often dominance is viewed in pejorative terms because it is said to effect inequitable distributions of wealth and power by concentrating both in the hands of dominant firms. Do such concerns justify a law which applies especially to market conduct by dominant firms? Second, do dominant firms have any special power to engage in rent seeking behaviour? A survey of the leading cases reveals that implicit in many of the decisions interpreting dominance laws is the belief that dominant firms have a power to engage in certain market conduct which is unique to dominant firms. If such a unique power exists it may justify a law which only applies to dominant firms. We address these two important questions separately in the two chapters that follow.
Chapter 4: Is Dominance Socially Undesirable?

To this point we have argued that the possibility of achieving market dominance, or relative freedom from competitive constraint, is an inherent part of the dynamic of the process of competition. We have proposed that dominance itself ought not be of regulatory concern, rather competition laws ought to focus upon rent seeking conduct which inhibits the responsiveness of other firms to compete for the supra normal profits being earned by the innovator. In this chapter we consider whether there are any other socially undesirable aspects of market dominance which justify the existing regulation of dominant firms. We emphasize that we are concerned with competition policy, not government policy in general, a distinction the significance of which will become apparent in the balance of this chapter. Aside from arguments based upon the effects of dominance upon total welfare (an issue considered in detail in the previous chapter), dominance is usually attacked as effecting and sustaining inequitable distributions of wealth and power by concentrating both in the hands of dominant firms.\(^{172}\).

**Equitable Distribution of Wealth and Power**

It is common for the wealth distribution effects of the market system to be ignored in framing competition policy. It is usually argued that the market is an instrument for maximizing total welfare and that the issue of distributional equity should be addressed by

other government interventions such as taxation and welfare policy\textsuperscript{172}. There are notable exceptions which argue for an integration of the two objectives of wealth maximization and distributional equity in framing competition laws\textsuperscript{174}. Therefore, it is important to understand the impact of the process of competition upon the distribution of the wealth which it generates. There are two main ways in which the market system may be perceived as causing the inequitable distribution of the wealth which it maximizes.

The first arises because there must be ownership of resources by individuals for a market to be created. Once ownership is established there can then be an exchange of goods and services\textsuperscript{175}. But, at any point in time resources will be unevenly divided amongst the population. This inequality in distribution raises a number of issues. The allocation of resources by the market mechanism is based upon demand for those resources. Demand is significantly affected by wealth. The more an individual owns the more that person will value certain goods and services; such as yachts, vacations, restaurants, fine clothes and jewellery. Therefore, the distribution of resources dictates the allocation of resources that results from exchange in the marketplace. If, on a global scale, resources were to be transferred from the world’s wealthiest nations to the people of the world’s most impoverished nations we would expect a substantial rise in the global demand for food.

\begin{itemize}
\item[\textsuperscript{172}] This is the basic approach adopted by applied welfare economics generally; A. Harberger, "Three Postulates for Applied Welfare Economics: An Interpretive Essay" (1971) 9 J. Econ. Lit. 785. For a discussion of the interaction between policies which evaluate the net benefits of a regulatory policy without regard to the individuals who receive those benefits (and those who may lose in order to create the net benefit) and the issue of redistributive taxation; see Hay & Morris, 568-90.
\item[\textsuperscript{174}] Elzinga, \textit{supra}, note 4 at 1202 argues that equity goals in general and distributional goals in particular are promoted by a law directed at promoting efficiency. "Equity goals such as more egalitarian distribution of income and the deterrence of racial discrimination are indirectly and costlessly promoted by a direct attack on inefficient, anticompetitive market structure and practices. See also, Pitofsky, \textit{supra}, note 4.
\item[\textsuperscript{175}] L.G. Telser "Cooperation, Competition and Efficiency", (1985) 28 J. of Law & Econ 271 at 272-7.
\end{itemize}
clothing and education and a fall in demand for luxury goods and services. In one sense
the "demand" for these goods has not changed, just the capacity of certain people to give
them value.

The demand to which the market mechanism responds, and the efficient equilibrium
which it generates, is a function of current resource allocations. At any point in time, any
change in the distribution (or ownership) of existing resources will produce a dramatic
change in their allocation amongst goods and services. But from the perspective of the
market mechanism, even though the equilibria reached will differ depending upon the
distribution of ownership of resources, each will be allocatively efficient176.

The significance of such observations in the context of dominant firms is that, as we
have already observed177, the monopoly pricing of dominant firms results in a transfer of
total surplus from buyers to sellers. Therefore, it may be argued that dominance ought to
be proscribed as it results in an allocation of resources which tends to prefer the demands
of the owners of dominant firms.

There have been attempts to create markets that redress the impact of existing
distributional inequities178. However, it is important to recognize that the impact of
distributional inequity cannot be wholly redressed by continuously equalizing resource
ownership through welfare distributions or by state ownership or, indeed, be eliminating

176 Hay & Morris, supra, note 4 at 569.

177 See above, text relating to note 57.

178 Nevertheless there are those who argue that private markets remain the most efficient and equitable
way to organize the provision of education because people will invest in the human capital of education in
proportion to the potential of each individual which leads to allocational efficiency. The only government
intervention that is needed is to redress failures in finance markets that are reluctant to finance education
costs; P.K. Porter and M.L. Davis, "The Value of Private Property in Education: Innovation, Production and
dominance. To do so would be to destroy the underlying incentive effect of the market mechanism, namely the private interest to maximize profits. However, to the extent that such transfers go beyond what is the necessary incentive for innovation, they may be seen as being inequitable. Therefore, it may be said that an absence of competition produces not only allocational inefficiencies, but also inequities in the distribution of income. This is an issue which we addressed in detail in the previous chapter where we argued that our approach to the regulation of the socially undesirable market conduct associated with dominance will prohibit unnecessary profit incentives for innovation. That is to say, it will tend to limit supra-normal profits to those which are necessary in order to encourage innovations which improve the welfare of society as a whole.

Secondly, in societies which value democracy, there are those who argue that aggregations of wealth in the hands of a few producers (or the owners of capital in such firms) is undesirable as it creates economic power which enables such firms to have an unreasonable influence upon society, even though such power may be simply the outcome of successful competitive strategies. Therefore, equity and fairness requires societies to trade off the goal of maximizing welfare against the goal of maximizing the voice of each member of society in its political structures. Such an approach necessarily questions the absolute importance of wealth maximization which has been the unspoken premise behind our analysis of the process of competition to this point.

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179 The result is a tension between goals of efficiency and equity; Elzinga, supra, note 4 at 1194ff. This is a consequence which is evident in the formulation of taxation policy.

180 See above, c.3 - The Welfare Effects of Rent Seeking.


182 Ibid.
Whilst these observations show that it is possible to question the equity of the distribution of wealth effected by the market system, there is no means by which the market system may be regulated to achieve a particular distributional outcome. To the extent that policies are required to redress perceived inequities in existing distributions of wealth in a market economy, those policies must be external to the market mechanism\textsuperscript{183}. The reason is well articulated in the following recent statement by the Director of Investigation and Research of the Bureau of Competition Policy in Canada concerning wealth transfer effects of markets. The statement was made in the specific context of merger policy, but applies to competition laws in general.

Economists have advocated treating wealth transfer neutrally owing to the difficulty of assigning weights \textit{a priori} on who is more deserving of a dollar. Even considering that some system of weighting could be articulated, the practical implications of this are likely insurmountable - for, who is losing and who is receiving the transfer? Shares are often widely held in public companies. Are the shareholders of pension-fund investors in a firm more or less deserving than the customers of that firm? Moreover, who are the customers? In cases of intermediate products, is one looking to the shareholders of the consuming companies or to their customers\textsuperscript{184}?

Whilst there must be policies that ensure an equitable distribution of wealth within society, it is extremely difficult to formulate any regulation that adjusts the distributional outcomes of the market system to conform to any given perspective of equity\textsuperscript{185}. The process of

\textsuperscript{183} Areeda & Turner, \textit{supra}, note 7, vol. 1 at 21-31.

\textsuperscript{184} Consumer and Corporate Affairs Canada, Speech S-10728-92-07, "Decisions and Developments: Competition Law and Policy, Remarks Delivered by Howard I. Wetston, Q.C. Director of Investigation and Research Bureau of Competition Policy to the Canadian Institute, Toronto" (June 8, 1992).

\textsuperscript{185} One of the advantages of the market system is that choices do not need to be made between who is more deserving of "wealth". See also, Williamson, Limits of Antitrust, \textit{supra}, note 103 at 108 ("Macroeconomic policy instruments (taxes, transfers, expenditures) with which to correct distributional conditions are not only available but superior to the use of antitrust for this purpose").
competition requires the potential for innovators to earn supra-normal profits\textsuperscript{186}. Equity requires that such profits be kept to a level which is necessary to serve the common good through the encouragement of innovation. Arguably, considerations of distributional equity, suggest that, so far as possible, competition laws should ensure that supra-normal profits are kept at the minimum level necessary to encourage innovation. However, it is quite possible, through the redistribution of wealth, to reduce, or even eliminate, the incentive to innovate. Further, the point at which incentive is reduced will vary depending upon the context\textsuperscript{187}.

The distributional consequences of competition are diffuse. Without a doubt, an inherent aspect of the market system is the creation and exploitation of the ability to earn supra-normal profits. Supra-competitive pricing redistributes wealth from buyers to sellers. Over time it prefers the needs and preferences of those able to charge supra-competitive prices over others. But to focus on the wealth distribution effects of supra-normal profits ignores the other part of the cycle of competition in which the market system itself directs the efforts of others in the market towards the elimination of that profit opportunity through imitation. In a very real sense there is distributional equity inherent in the process of competition as the tide of competition itself eliminates supra-normal profits over time.

While a direct assault on inequality through income distribution might lead to a reduction in efficiency, a direct assault on inefficiency through antitrust will not necessarily result in a reduction in equality. It is far more likely to lead to an actual gain for equality...In the long run, more competition will mean

\textsuperscript{186} Although there is research to suggest that inventiveness is unrelated to the profit opportunities that it may present, we are concerned with a much broader concept of innovation which encompasses any change by a competitor in order to create an opportunity for supra-normal profits no matter how small or transitory that opportunity may be.

\textsuperscript{187} See above, text relating to note 142ff.
less accumulation of wealth from capitalized monopoly positions...In sum, the pursuit of efficiency through antitrust enforcement is consistent with the objective of equitable
distribution of income\textsuperscript{188}.

Competition laws which promote the process of competition and reduce exclusionary practices can be seen as part of a package of regulations which achieve distributional equity. Their compliment is a taxation policy which allows the deduction of expenditure relating to attempts to innovate, but which taxes the actual gains of innovation after the event (coupled with welfare policies for the redistribution of wealth). It is contended that such policies will advance distributional equity without significantly distorting the ability of the market system to increase total welfare. The only alternative is to attempt to regulate all supra-competitive pricing on the basis that it is distributionally inequitable. But such an approach would destroy the market system's substantial ability to maximize total welfare, by eliminating the driving force behind competition - supra-normal profits.

Nevertheless, there are concerns associated with dominance. They relate to the impact which dominance has upon the tendency of the market to harness the self interest of firms to promote total welfare. Some rivalry in the market place promotes self interest to the detriment of total welfare. It is such rent seeking conduct that provides the rationale for competition laws.

\textbf{The Rationale for Regulatory Intervention}

Having explored in some detail what might be the socially undesirable market conduct associated with dominance we now propose a basis for regulatory intervention using

\textsuperscript{188} Elzinga, \textit{supra} note 4 at 1195.
competition laws. First, any law should promote the process of competition\textsuperscript{189}. That is, it should ensure that there is a balance between the maintenance of the incentive of supra-normal profits to drive firms to innovate and increase dynamic efficiency on the one hand and the opportunity for firms to imitate and increase productive and allocative efficiency on the other hand. Second, the law should recognize that the process of competition may result in markets which, from time to time, are closer to the state of monopoly than perfect competition. Third, the law should eliminate rent seeking practices because they are necessarily inefficient and, without regulation, they are encouraged by rivalry in the marketplace. Fourth, the law should be viewed as only a partial solution to the challenge to achieve distributional equity and democracy. Without taxation and welfare policies, the market system maximizes the production of those goods and services which are needed and desired by the wealthy and arguably concentrates economic and political power in the hands of innovators. Fifth, the law should recognize that, in some cases, there are factors exogenous to the conduct of firms that entrench dominance.

However, before considering the form which such regulation should take, we must first explore one further question which our approach to dominance raises. In short, given the propensity of the profit motive to drive firms to pursue rent seeking strategies are there any rent seeking strategies uniquely available to dominant firms which justify their especial regulation?

\textsuperscript{189} T. Calvini & M.L. Siborium, "Antitrust Today: Maturity or Decline" (1990) Antitrust Bulletin 123 at 125, argue that the debate, at least in the United States, as to the objectives that should be adopted for antitrust is now in the fourth quarter "with the preservation of competition the clear winner".
Chapter 5: Do Dominant Firms have a Unique Power to Engage in Rent Seeking in the Market Place?

In the dialogue between economists, policy makers, the legislature and the courts that produces competition laws, often "dominance" has been defined or described in ways which suggest that dominant firms have powers or abilities which other firms do not. Were such power to exist, it may justify a law directed specifically at dominant firms. In this chapter we argue that dominant firms have no unique powers in the market place. We accept that an existing dominant position may provide a significant motive to engage in conduct designed to protect that position and prevent the erosion of the additional profits which flow from a relative absence of competition as well as certain strategic advantages to do so. Such conduct will be directed at preventing other firms from competing with the dominant firm. However, we argue that any firm may engage in similar practices if it believes that it will be able to secure a dominant position as a result.

There are a number of concepts which tend to associate dominance with special power or ability in the market place. We will consider each in turn in order to show that it is wrong to characterize dominant firms as having special power in the market place. Rather, we will show it is more accurate to view the present existence or future prospect of dominance as an equally compelling motive for any firm to engage in conduct designed to prevent other firms from competing with it. The concept most commonly associated with dominance is market power.
Market Power

In economic terms a firm is dominant if it has a substantial degree of market power. Market power is the ability to profitably raise price above the level which would otherwise prevail in a perfectly competitive market\footnote{Landes & Posner, "Market Power in Antitrust Cases" (1981) 94 Harv. L.R. 937 ("market power is the ability of a firm (or group of firms acting together) to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded); V. Korah, "Interpretation and Application of Art. 86 of the Treaty of Rome: Abuse of a Dominant Position Within the Common Market" (1978) 53 Notre Dame Lawyer 768 at 770; Brenner, supra, note 110 at 44 ("Market power is the power of a firm to increase its profits by raising its price above marginal cost").} - a definition that has been adopted in many cases\footnote{In Australia, Queensland Wire, supra, note at 188 ("Market power can be defined as the ability of a firm to raise prices above the supply cost without rivals taking away customers in due time"); In Canada, Laidlaw, supra, note at ("In deciding whether a firm has substantial or complete control of a market, one asks whether the firm has market power in the economic sense. Market power in the economic sense is the power to maintain prices above the competitive level without losing so many sales that the higher price is not profitable. It is the ability to earn supra-normal profits by reducing output and charging more than the competitive price for a product"); and in the United States, N.C.A.A. v. Board of Regents 468 U.S. 85 at 108 ("market power is the ability to raise prices above those that would be charged in a competitive market").} Viewed in another way, market power is a measure of the degree to which a firm can engage in supra-competitive pricing and earn supra-normal profits. Measures of market power, as a result, tend to focus upon the profitability of firms in comparison to some form of established norm for profits\footnote{G.K. Ottosen, Market Power: How is it Measured and How has it Changed (Salt Lake City: Crossroads Research Institute, 1990); and H. Hovencamp, "The Measurement of Market Power: Policy and Science" in F. Mathewson, M. Trebilcock & M. Walker, eds., The Law and Economics of Competition Policy (Vancouver: The Fraser Institute, 1990) 43. The problem with such measures is well articulated by Brenner, supra, note 110 at 45 ("...market power...is a widespread phenomenon. No markets are perfect; as a result, most firms in the real world maximize their profits at prices above marginal cost"). Further, such measures do not identify the source of market power - whether it derives from innovation or rent seeking behaviour).}. As was evident from our discussion of competition, the potential to earn supra-normal profits is a key aspect of the process of competition. Indeed our analysis of the process of competition can be expressed in terms of market power.

Firms which are innovative in the broad sense in which we have used that term, will acquire market power. In doing so they will improve total welfare, though the extent to
which they do so depends upon the value of the innovation. However, because market power is created by a move away from the competitive equilibrium, to maintain the allocative efficiency of the market mechanism requires the elimination of market power. The existence of market power will itself attract firms to imitate the strategies of the innovative firm. In addition, the profits to be earned through market power will motivate all firms with market power to find ways other than innovation to exclude competition and thereby prevent the erosion of that market power by others.

However, the fact that a firm has market power does not mean that it will automatically have the power to prevent the process of competition from eroding that power. An example is the computer industry. Although IBM was able to be the leading innovator in the industry and, for a significant period, extract supra-normal profits, in time the process of competition through imitation and further innovation by other firms eroded that power.

Of course, initially the innovativeness of IBM made it difficult for other firms to compete with IBM thereby sustaining IBM's market power. But the fact that a firm has market power at any point in time, evident through its ability to extract supra-normal profits, does not mean that it has any ability to entrench that position through conduct which stems the tide of the process of competition. Although the extent to which imitation is delayed can create and entrench market power, the possession of market power does not lead necessarily to the ability to delay the erosion of that power. Certainly IBM has been accused of adopting strategic exclusionary practices designed to delay the process of

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193 Shepherd, supra, note 141 at 146.
competition. Such practices are not innovative, they are merely designed to make things more difficult for rivals. Without such practices, the only obstacles to imitation would be the ability of rivals to imitate the successful actions of IBM and the time taken to do so.

In short, market power is the outcome of a delay in the competitive process that may be endogenous or exogenous to the firm. A firm with market power has the ability to engage in supra-competitive pricing, but the true power lies in that which is the source of the ability to earn supra-normal profits. A firm with market power may well be impotent when it comes to protecting that power. On the other hand the strategies that may be pursued to secure or protect market power are available to all firms. As a result, it might be said that to define dominance in terms of market power is to miss the main point.

Certainly, the exercise of market power leads to allocative inefficiency and internal inefficiency and transfer of surplus. However, it is the source of the market power, rather than the mere fact of its existence, that is relevant to the promotion of total welfare. If its source is innovativeness, then it will be welfare enhancing. If its source is strategic exclusionary conduct to entrench or protect market power (rent seeking), then it is likely to reduce welfare through allocative inefficiency. If its source is external to the conduct of the firm, such as the result of a statutory licensing scheme, then it is also likely to reduce welfare through allocative inefficiency (and perhaps also X inefficiency). However, in the last case no complaint may be made concerning the market conduct of the dominant firm.

Market "power" is something of a misnomer. The power to engage in supra-normal pricing is sustained not by dominance per se, but by the source of the dominant position.

194 Ibid.

As to the source of dominance, all firms have the power to engage in innovation or rent seeking that may create or sustain dominance.

**Barriers to Entry**

Those structural factors which differentiate a market from the state of perfect competition (and tend to create the state of monopoly) are termed "barriers to entry". Dominance is often described in terms of barriers to entry suggesting that the barriers operate as a form of permanent shield protecting dominant firms from the forces of competition and enabling them to engage in activities which are not possible for firms subject to competitive constraint\(^{196}\). Significant entry barriers have been described as the "sine qua non of monopoly and oligopoly, for...sellers have little or no enduring power over price when entry barriers are nonexistent"\(^{197}\).

If there are absolutely no barriers to entry, there can be no effective exercise of market power...This...is the basic message of contestability theory. If outsiders can enter and insiders can exit at will, as if on roller skates, then no one can raise prices without drawing entry; no one can predate without inducing costless exit; and concentration does not matter. With perfectly free entry and exit, everything is competitive as a matter of logic\(^{198}\).

Such analysis leads to the conclusion that because of the barriers to entry, dominant firms have a special ability to maintain their supra-normal pricing. However, such an approach falls into error because it lacks any temporal perspective. The inference is that a market

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\(^{196}\) E.g., Korah, *supra*, note 190 and *Queensland Wire*, *supra*, note 23 at 201-2.

\(^{197}\) Scherer, *supra*, note 4 at 11.

either has relatively "high" or "low" barriers to entry. Indeed, Bain, in the first comprehensive study of entry barriers, stated

We have emphasized throughout that the condition of entry is a structural concept, and that it is evaluated by the extent to which established firms can, on the average over a long period, elevate price above a long-run competitive level while still forestalling entry.

Bain's perspective was framed by the state of perfect competition and he defined barriers to entry in terms of those aspects of industrial organization which prevent the state of perfect competition from being established. The extent to which this pervades his analysis is evident in his characterization of the process of change as external to the competitive forces in the market. Bain posits that conditions of entry are "usually stable and slowly changing through time, and are not generally susceptible to alteration by prospective entrants to various markets". Thus, the process of competition is seen as taking place within the structural limitations created by barriers to entry.

However, others have emphasized how many barriers to entry have been created or influenced by conduct by incumbent firms. Barriers may be unrelated to the process of competition, but in many cases they may be explained by reference to conduct undertaken by firms in the pursuit and protection of supra-normal profits. Market

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199 J.S. Bain, Barriers to New Competition: Their Character and Consequences in Manufacturing Industries (Cambridge, Mass: Harvard University Press, 1965) at 17.

200 Ibid. at 17-8.

201 Ibid. at 18.

202 Stigler, supra, note 47 at 67-70; and Krattenmaker, Lande & Salop, supra, note 195 at 254-5.

203 W.G. Shepherd, "Theories of Industrial Organization" in H. First, E.M. Fox, & R. Pitofsky, Revitalizing Antitrust in its Second Century: Essays on Legal, Economic, and Political Policy (New York: Quorum, 1991) 37 at 53-4 sets out a comprehensive summary of imperfections in market structures (barriers to entry) which permit "average or inferior firms to attain dominance", many of which may be influenced by the firm seeking
structure itself is influenced significantly by competitive behaviour. To view dominance as the outcome of a market structure in which competitive entry is difficult due to the height of barriers to entry ignores the role which the process of competition plays in creating those barriers, and exploiting other barriers external to the conduct of the firm, in order to protect supra-normal profits. The causal relationship between market structures and the process of competition is not linear (in either direction) - they shape each other.

To define dominance as a function of structural considerations external to the firm suggests that there is a distinct "dominant firm" market structure with its own equilibrium in which the profit motive causes the dominant firm to exploit its market power in much the same way that the competitors in an oligopoly are portrayed as being driven by the profit motive to pursue welfare reducing cooperative strategies through parallel behaviour or collusion. Dominance itself and the barriers to entry that sustain it are seen as the evil, irrespective of the factors that have led to the creation of the position of dominance.

Further, structural constructs lead to solutions which are perceived to move the market closer to the structure of perfect competition in order to remove the "power" which dominance allegedly affords. In the past, recognition that the theoretical extreme of perfect competition is unattainable due to the divergence of the real world from the assumptions that underlie the model led to the development of the concept of "workable

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204 S. Salop, "New Economic Theories of Anticompetitive Exclusion" (1987) 56 Antitrust L.J. 57 at 63 ("exclusion itself can create or raise entry barriers and thereby give a firm power over price").

205 E.g., Bain, supra, note 4 at 503ff.

206 The result is a competition policy that focuses upon reducing concentration; Fox & Sullivan, supra, note 52 at 6ff; Stigler, supra, note 47 at 261ff; Bain, ibid; Gorecki & Stanbury, supra, note 44 at 131; and J.P. Niewenhuysen, "The Theory of Competition Policy" in W. Ransom & W. Pengilley, Restrictive Trade Practices: Judgments, Materials and Policy (Sydney: Legal Books, 1985) 20.
competition" to describe a market structure in which there was sufficient competition to constrain the development of market power. Though some understood workable competition as a behavioral concept, describing the conduct of firms in the marketplace\textsuperscript{207}, the mainstream expressed it in structural terms\textsuperscript{208}. Invariably there were expressions of the nature of barriers to entry associated with the structure of workable competition\textsuperscript{209}. However, the problem with any structural perspective is that barriers to entry are perceived as conferring especial power in the market place (and therefore as necessarily undesirable and something to be dismantled by regulation) when they should be seen as an outcome of many types of rivalrous activity without which there would be no barriers to entry and no "power". Barriers to entry may be the result of welfare enhancing conduct by a firm, such as innovation or the exploitation of economies of scale, or factors external to that firm which are also welfare enhancing, such as demand that makes one firm scale efficient, or a unique geographical location.

Further, barriers to entry are not impervious to change. It is to be expected that dominant firms will attract competition due to the supra-normal profits that they enjoy. Therefore, the pressures in a dominant market comprise a struggle between the incumbent to protect market power and entrants wishing to contest for those profits. In that context, a structural perspective of dominance fails to address the key issue whether the barriers to entry are the outcome of changes in the market which are welfare enhancing, or the result

\textsuperscript{207} Clark, supra, note 36 c.1.

\textsuperscript{208} S.H. Sosnick, "A Critique of Concepts of Workable Competition" (1958) Q.J. of Econ. 381.

\textsuperscript{209} C.D. Edwards, Maintaining Competition (New York: MacMillan, 1949) at 901 ("New traders must have opportunity to enter the market without handicap other than that which is automatically created by the fact that others are already well established there"); and Scherer, supra, note 4 at 42 ("There should be no artificial inhibitions on mobility and entry").
of rent seeking conduct by the dominant firm which is successfully stemming the tide of entry, or the consequence of external factors which are beyond the influence of the incumbent or prospective entrants.

Importantly, any firm may engage in market conduct which creates or exploits barriers to entry. Further, there is nothing about the existence of the barriers per se that empowers a dominant firm to maintain them. Once again the regulatory issue is not the barriers per se, but the conduct by firms which may create such barriers and whether such conduct is socially desirable.

Monopoly Power

The courts in the United States have often referred to dominant firms as those with monopoly power. Although economists use the terms market power and monopoly power interchangeably to mean the power to profitably reduce output and raise prices, the American courts use monopoly power in a different sense. An example is the following passage from the decision of the District Court in United States v. Griffith

Section 2 [of the Sherman Act] is not restricted to conspiracies or combinations to monopolize but also makes it a crime for any person to monopolize...So it is that monopoly power, whether lawfully or unlawfully acquired, may itself constitute an evil and stand condemned under s.2 even though it remains unexercised. For s.2 of the Act is aimed, inter alia, at the

210 In the context of s.2 of the Sherman Act, the courts have referred to monopolization (or creation of dominance) as the outcome of monopoly power which, in turn, has been defined as "the power to control prices or exclude competition"; United States v. E.I. du Pont de Nemours & Co 351 U.S. 377, 391 (1966) [hereinafter Cellophane]; and United States v. Grinnell Corp 384 U.S. 563, 571 and Aspen Skiing Co. v. Aspen Highlands Skiing Corp. 472 U.S. 585, 596 (1985) [hereinafter Aspen].

211 Krattemaker, Lande & Salop, supra, note 195 at 179; and Shepherd, supra, note 4 at 2-3 (where the terms are used interchangeably).

212 334 U.S. 100 (1948).
acquisition or retention of effective market control...Hence the existence of power "to exclude competition when it is desired to do so" is itself a violation of s.2, provided it is coupled with the purpose or intent to exercise that power...It follows, a fortiori that the use of monopoly power, however lawfully acquired, to foreclose competition, to gain a competitive advantage, or to destroy a competitor, is unlawful\(^{213}\).

Putting to one side the emphasis upon the bare existence of monopoly power being a contravention of the law\(^{214}\), it is apparent that what is meant by monopoly power is the ability to exclude competition on an ongoing basis\(^{215}\). As discussed at the outset of this chapter it is conduct which has the effect of excluding competition that creates market power. Market power itself does not exclude competition. Rather, it is the ongoing ability to exclude competition that sustains market power. It follows that in the sense in which the term is used in the *Griffith Case*, monopoly power is not a synonym for market power. Instead monopoly power is used to describe that ability which is the source of market power. Dominant firms have monopoly power, or, in other words, the power to exclude competition\(^{216}\). As such, monopoly power is really the dynamic complement to barriers to entry. Barriers to entry are the means by which dominant firms may exclude competition. Monopoly power is the ability to create and exploit barriers to entry.

However, as in the cases of market power and barriers to entry, monopoly power

\(^{213}\) Ibid. at 106-7.

\(^{214}\) Such emphasis does not reflect the current law in the United States which focuses upon purpose; see *Kodak*, supra, note 19 and *Aspen*, supra, note 209 and the discussion below; see c.6.

\(^{215}\) See also, *Cellophane*, supra note 210 at 391 ("the power to control prices or exclude competition" is "the primary requisite to a finding of monopolization"); and *Kodak*, supra, note 209 at 272ff. A similar concept has been expressed in the European cases; e.g., *Deutsche Grammophon v. Metro* (1971) E.C.R. at para. 17; and *United Brands v. Commission* (1978) E.C.R. 207 [hereinafter *United Brands*].

\(^{216}\) The classic definition of market power in the United States is "the power to control prices or exclude competition" (see above, note 210), a definition which seems to incorporate the notion of market power referred to above.
may be obtained and exercised by all firms. The United States courts have long recognized that monopoly power may be derived from competitive "skill, energy and initiative"\textsuperscript{217}. Much of the case law in the United States is devoted to distinguishing between those firms that have dominance thrust upon them due to their superiority in the marketplace and those firms that achieve dominance through exclusionary conduct\textsuperscript{218}. The courts have repeatedly stated that having been encouraged to compete, dominant firms must not be penalized for their competitive success. Although dominant firms may be defined as those that have the power to exclude competition, dominance itself may be socially desirable or undesirable depending upon the nature of the monopoly power that sustains it. Monopoly power that is derived from superior innovation may be socially desirable. All firms may engage in exclusionary conduct and will be motivated to do so provided that they expect the supra-normal profits that will be secured as a result will outweigh the cost of investing time and money in excluding competition.

**Strategic Motive and Advantage**

To this point we have argued that the conclusion, implicit in the concepts of market power, barriers to entry and monopoly power, that dominant firms have a unique ability to engage in socially undesirable market conduct is invalid. Properly understood those concepts simply confirm our analysis that the prospect of achieving a position of dominance is a motive for all firms to adopt strategies that result in relative freedom from competitive constraint. Of those strategies, it is only rent seeking behaviour that is socially undesirable.

\textsuperscript{217} A concept originating in \textit{Alcoa, supra}, note 14.

\textsuperscript{218} See below, c.6.
However, it is wrong to suggest that a dominant firm is as likely as a firm subject to competitive constraint to invest in rent seeking activities. It must be acknowledged that dominant firms have a greater propensity to engage in such activities for two reasons. First, because they have a greater interest to do so in order to protect their existing supra-normal profits. Second, and more importantly, there will frequently be certain strategic advantages associated with an existing dominant position that assist in pursuing certain rent seeking strategies. In short dominant firms have strategic motive and advantage when it comes to rent seeking.

As to motive, not only does the dominant firm have an existing line of supra-normal profits that it will want to protect, it will often have substantial investments in existing technology. It has a substantial interest in preventing others from adopting innovations that will make such technology redundant\(^{219}\).

As to the advantage of dominant firms the literature is substantial. Rent seeking strategies depend upon a number of factors, many of which are likely to favour dominant firms. Rent seeking is more likely to be successful where there are financial or informational asymmetries\(^{220}\). Dominant firms are characteristically well established with substantial retained earnings, both of which lead to lower financing costs for dominant firms. The lower cost of capital, or financial advantage may be exploited in rent seeking

\(^{219}\) As observed by Scherer, *supra*, note 4 at 428 "a company that already dominates the market it supplies has little to gain by speeding up the introduction of product improvements as long as other firms refrain from doing so". By extension, it has much to gain from preventing the introduction of such improvements by others. There is also evidence that new entrants play a crucial role in technological progress which supports the view that incumbents are less motivated to invest in innovations that would make the technology that sustains their dominant position redundant, *ibid.* 438.

strategies. One interesting example is the use of oppressive litigation, particularly competition law suits in those jurisdictions where private actions are possible, to burden the financially weaker entrant\textsuperscript{221}. As to informational asymmetries, being the incumbent in an industry a dominant firm is likely to have an informational advantage over a new entrant that can be exploited\textsuperscript{222}. A dominant firm may exploit its informational advantage by investing in developing a "tough" reputation which discourages new entry\textsuperscript{223}. Also a dominant firm may often have the ability to invest in sunk costs which may be an effective entry deterring strategy.

An appropriately positioned incumbent confronts a potential entrant with the certainty that if entry occurs both will fail to cover their total cost. The incumbent cannot avoid this, having sunk his capital. The potential entrant can avoid these losses by staying out and presumably does so\textsuperscript{224}.

Despite these advantages, rent seeking is not exclusively the province of incumbent dominant firms. The literature concerning raising rivals costs, a form of rent seeking, is not preconditioned upon an existing position of dominance. It shows how any firm may invest in strategies which raise the costs of rivals in order to achieve relative freedom from competition and attendant market power\textsuperscript{225}.

Even if a firm does not have single firm market power [ie. it is not dominant] - that is, even if the firm has no power to raise price by restricting its own output, it may still have the power

\textsuperscript{221} Baumol & Ordover, \textit{supra}, note 113 at 87. See also, \textit{Laidlaw}, \textit{supra}, note 8; and (Australian case in which has been argued) in which it was alleged that resort to competition law litigation was itself an abuse of dominance.

\textsuperscript{222} See McFetridge, \textit{supra}, note 220.

\textsuperscript{223} McFetridge, \textit{supra}, note 220 at 78-9; Dunlop, McQueen and Trebilcock, \textit{supra}, note 8 at 223.

\textsuperscript{224} McFetridge, \textit{supra}, note 220 at 78.

\textsuperscript{225} Krattenmaker & Salop, \textit{supra}, note 101.
to raise rivals' costs and thereby gain power over price. Rather than restricting its own output, and thereby driving price up [which it does not have the power to do], it can push price up by raising its competitors' costs. Once their costs are raised, they will then be forced to reduce their output, and if they reduce their output, then price will rise, as night follows day.\textsuperscript{226}

Equally, there may be cases where the information asymmetries give the advantage to a new entrant. This may well be so where the entry results from an innovation the precise cost benefits of which are unknown to the incumbent dominant firm.\textsuperscript{227}

Therefore, we must be careful not to view the strategic advantage which dominance provides to enable some firms to engage in rent seeking as a defining element of rent seeking. Dominance is not a part of the definition of rent seeking conduct. As a result, to include dominance as an element of any offence will have two effects. First, it will exclude from the operation of the law all rent seeking by firms which are not in a position of dominance at the time that they engage in rent seeking behaviour. Second, it requires the proof of an unnecessary element. It would be similar to requiring, in an assault case, proof that the person perpetrating the assault met a "dominance" standard that was likely to produce a physical advantage. Size is relevant in an assault case. A larger and physically stronger person has certain advantages when it comes to perpetrating an assault. However, that is no reason to exclude smaller, weaker persons from our assault laws. Simply because dominance is one means of facilitating rent seeking does not mean that it should be

\textsuperscript{226} Salop, supra, note 204 at 62.

\textsuperscript{227} E.g., consider the facts in Alcoa, supra, note 14. The investment by Alcoa in excess capacity may have begun prior to its attainment of a dominant position. Assuming such investment was motivated solely by a desire to exclude future entry, and not by the belief that it was necessary in order to serve the needs of customers in a timely manner by preventing shortages in the future, it would represent an investment in rent seeking practices prior to achieving dominance.
included as an element of any law regulating socially undesirable market conduct associated with dominance\(^{228}\).

In short, although dominance may be a powerful motive to engage in rent seeking practices and, in certain contexts, may facilitate some types of rent seeking, such activities do not lie exclusively within the capability of dominant firms. Rent seeking is just as detrimental to total welfare if it is adopted by a firm that is not dominant.

**Dominance as a Filter**

Public policy analysis requires the cost of any economic regulation to be less that the social cost of the conduct being regulated\(^{229}\). Can the regulation of dominant firms alone be justified on a cost-benefit basis? Will dominant firms be more likely to engage in the more socially damaging rent seeking? Intuitively, the research concerning entry deterring strategies and the advantages which dominant firms enjoy in many instances (referred to above\(^{230}\)) may suggest an affirmative answer. However, should dominance be used as the filter to ensure that the regulation only applies to those activities with a significant negative impact upon total welfare - sufficient to outweigh the costs of enforcement? If, as our analysis suggests, it is rent seeking that is the socially undesirable market conduct associated (i.e. motivated by) dominance, why not qualify the rent seeking behaviour to which any regulation applies to ensure that any *de minimus* conduct is excluded? Such a rule would

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\(^{228}\) In addition dominance has proven to be an extremely complex concept, raising difficult issues of proof; see below, c.6 - Other Advantages of Rejecting Dominance as a Basis for Regulation.

\(^{229}\) Mishan, *supra*, note 171 at c.23.

\(^{230}\) See above, c.5 - Strategic Motive and Power.
ensure that only market conduct with a significant welfare effect was proscribed\textsuperscript{231}. The qualification to the regulation would then relate to the nature of the rent seeking conduct, rather than some questionable link between existing dominance and the most serious rent seeking activities. The form which such a qualification may take is discussed below\textsuperscript{232}. We reject any argument that dominance should be retained as a filter in any law proscribing rent seeking behaviour\textsuperscript{233}.

A Synthesis

Dominant firms will have market power and monopoly power and they will be protected by barriers to entry which enable them to act in a way which firms subject to competitive constraint are unable to act. However, such power may be the reward for a successful competitive strategy. Such strategies are only socially undesirable if they are sustained by rent seeking. A position of market dominance (that is, relative freedom from competitive constraint) is not a necessary precondition to engaging in rent seeking. A dominant position is not the means by which firms engage in rent seeking, rather a position of dominance is the motive for such behaviour. Any firm can engage in rent seeking. Certainly, there are more incentives for the incumbent dominant firm. It is protecting its existing profits, whereas another firm would be investing in the prospect of future supra-

\textsuperscript{231} \textit{E.g.}, consider the facts in \textit{Cellophane, supra}, note 210. The result was governed by a finding that du Pont was not a dominant firm, due to a finding of a comparatively broad "relevant market" as the basis for assessing whether du Pont had a substantial degree of market power. The decision as to the relevant market has been often criticized. The result may well have been different if the focus of the court had been the conduct of du Pont, rather than the "preliminary issue" of defining the relevant market.

\textsuperscript{232} See below, c.6.

\textsuperscript{233} Excluding the concept of dominance from any regulation has other advantages; see below, c.6 - The Advantages of Rejecting Dominance as a Basis for Regulation.
normal profits. Some rent seeking strategies are uniquely available to dominant firms. Nevertheless, it must be acknowledged that non-dominant firms may engage in rent seeking and will do so provided they see an opportunity to secure dominance (and the resultant supra-normal profits) as a likely outcome. It is true that rent seeking is uniquely associated with dominance. However, it is more accurate to consider the prospect of dominance as the motive for rent seeking, rather than an existing dominant position as providing the power to engage in rent seeking practices. There should be a law that proscribes significant rent seeking behaviour by all firms.
Chapter 6: Precisely What is the Difference Between
Competition and Rent Seeking?

The question which now arises, and the point to which we have been leading, is
whether it is possible to formulate a rule which applies to conduct by all firms that inhibits
the ability and responsiveness of other firms to compete for the supra-normal profits being
earned by an innovator, without eliminating the incentive to innovate. This is the enquiry
which we contend will reveal the efficacy of any proposed alternative to the existing
regulation of dominant firms. Put shortly, will the proposal prohibit the socially undesirable
aspects of rivalry (rent seeking) whilst still preserving the socially desirable aspects
(innovation and imitation)? The task is to differentiate between conduct which is a welfare
improving response to the profit incentive which drives the market system and conduct
which is welfare reducing. Our analysis shows that it involves differentiating between
competitive and rent seeking conduct in order to prohibit rent seeking conduct in the
marketplace.

At the outset we must recall that, to a significant extent, we have already articulated
the distinction between competition and rent seeking. We have defined competition as "the
process or activity of innovation or imitation"; innovation as "a change in product,
production process or demand created by a firm"; and imitation as "the activity of copying
successful innovations by other firms". These are definitions that reflect our understanding
of competition as a dynamic process - profits are to be made in producing, as cheaply as
possible, those products which consumers desire (a process which also may involve
convincing consumers that a product is desirable). If one firm does not supply what
consumers demand as efficiently as possible, then its competitor will because there will be
profits to be made in doing so. In this way competition encourages firms to adopt changes which promote total welfare because such changes are profitable for the reason that they are demanded by customers. Competition also motivates firms to copy and maintain those changes for which demand exceeds existing supply and to reject those changes which, by reason of the lack of demand, are evidently not welfare improving. Of course, the reason such strategies are rejected is not due to any altruistic desire on the part of the firm to increase the total welfare of society. Rather, they are rejected because they are unprofitable. However, it is the fact that competition motivates firms to reject such welfare reducing activities that is significant. In short, our analysis shows that the dynamics of the competitive process are welfare improving because they are a response to customer demand.

Rent seeking, however, is the antithesis to competition. We have identified such rent seeking behaviour as "the process or activity of preventing innovation or imitation". Rent seeking does not meet customer demand. Rather, it is guided by the profit opportunity to be derived from preventing other firms from meeting an existing or prospective customer demand. As a result, economists usually define rent seeking behaviour as investment in distribution, rather than creation, of wealth. Rent seeking activities are parasitic\(^{234}\). They produce nothing. In the context of supra-normal profits, rent seeking is usually defined as wasteful expenses incurred to secure or maintain a monopoly position\(^{235}\). A rent seeking firm need make no change in product, production process, or attempt to influence demand in order to earn supra-normal profits. Rather, such a firm simply prevents imitation or

\(^{234}\) Brander, *supra*, note 93 at 49.

\(^{235}\) Tirole, *supra*, note 47 at 76.
innovation by other firms that would enable them to earn a share of the opportunity to earn supra-normal profits which the rent seeker wants to monopolize. Rent seeking behaviour makes no positive contribution to total welfare, it simply distracts energy and effort into distributing existing wealth to the rent seeker.

Therefore, in dynamic terms, the distinction between competitive behaviour and rent seeking behaviour can be expressed simply in terms of the extent to which the conduct is a response to, or an attempt to influence, consumer demand. Competitive behaviour meets consumer needs. Rent seeking behaviour prevents others from meeting consumer needs, or to put it another way, rent seeking behaviour prevents competitive behaviour. Rent seeking is simply not part of the dynamic by which the competitive process improves total welfare because it is does not seek to meet (or influence) consumer needs. A similar conclusion has been expressed by Fox, within the specific context of a discussion of when a refusal to deal is an abuse of dominance, as follows

A refusal to deal is allowed if it is simply an instance of choosing one's customers and of deciding how best to provide the goods and services that the consumer wants. A refusal to deal by a firm in a monopoly is impermissible if its natural effect is to lessen competition and thereby raise prices to consumers or otherwise degrade the price/service package offered to them.

The analysis may be guided by a series of questions. Was the refusal to deal a product of defendant's plan to wage more effective competition and to sell more goods and services by increasing consumers' satisfaction? Or was it a pressure tactic to eliminate or impose costs on a competitor and thereby to increase monopoly power or, at least, market share.\footnote{E.M. Fox, "Monopolization and Dominance in the United States and the European Community: Efficiency, Opportunity and Fairness" (1986) 61 Notre Dame L.R. 981 at 1001.}

To summarize, dominance is an inherent part of the process of competition because
it is the logical outcome of a system which is driven by profit maximization. The process of competition is driven by the pursuit of profits amongst rivals. Profits are to be made by serving customers more efficiently than any rival, or preventing any rival from serving customers with equal or greater efficiency. We argue in the balance of this chapter that recognizing that firms make profits from either serving customers or preventing other firms from doing so focuses the issue of differentiating between desirable and undesirable rivalry associated with market dominance in a way which is absent from existing regulatory approaches. In doing so, we contend that it is the failure to recognize such a distinction that has led to the difficulty which courts in all jurisdictions have experienced in differentiating "normal" competition from anti-competitive behaviour. The key to making the distinction lies in discerning whether the purpose of the conduct is directed at serving the needs of customers or frustrating the attempts of others to serve those needs.

It is important to note that by referring to the needs of customers we do not advance a rule based upon the customer's perspective as to whether particular market conduct is desirable, nor do we advocate some overall measure of the change in total welfare effected by the market conduct said to be socially undesirable. A customer perspective may support any conduct that results in lower prices and greater product variety over time. However, our analysis recognizes that the process of competition is driven by the potential for producers to earn supra-normal profits - a potential that may be realized only when a firm, due to the limited product variety available, is able to charge prices which are higher than those consistent with maximum allocational efficiency. We have argued that in order to maximize total welfare it is necessary to trade off allocational efficiency to secure the greater welfare returns generated through dynamic efficiency. Any regulation must promote
the cycle of innovation and imitation that makes up the process of competition. Consumers will not be able to enjoy the welfare gains that flow from innovation unless they are prepared to accept that there must be the opportunity to earn supra-normal profits for the innovator. Whilst, ultimately, consumers desire both maximum dynamic efficiency and maximum allocational efficiency, the former cannot be achieved without a trade off in the latter.

Therefore our point in referring to conduct which has the purpose of meeting or influencing the needs of consumers is not to refer to that competitive behaviour which will result in an optimal outcome so far as consumers are concerned, but instead to recognize that provided the strategies of producers are directed at supplying or influencing consumer needs then they will be promote the process of competition rather than frustrate or prevent it. It is not a consumer perspective that is material. Whereas a consumer perspective would support any legislative intervention that encouraged lower prices, our analysis supports innovative or imitative strategies that reduce prices, but advocates the proscription of rent seeking strategies such as strategic entry deterrence through predatory pricing. That which distinguishes the two is not the perspective of the consumer. Instead, it is the fact that in the first case the purpose of the producer is to supply the needs of the consumer, whereas in the second case there is only an attempt to prevent others from supplying those needs. The point is that in order to secure the welfare benefits of the innovation, the consumer must settle for something less than maximum allocational efficiency (at least until there is imitation in the market). The fact that differentiates the shortfall in maximum allocational efficiency inherent in offering the incentive of supra-normal profits to the innovator from the shortfall that results from rent seeking is the purpose of the producer.
Our approach does not involve an assessment as to whether the particular market conduct maximizes or promotes consumer welfare. Rather, having concluded in the previous chapter that innovation and imitation promotes total welfare and rent seeking reduces it, we now have shown that rent seeking is to be distinguished from innovation and imitation by asking whether the purpose of the producer was to serve or influence consumer needs. We intend this to be a factual enquiry divorced from the concepts of consumer or total welfare. In short, the conclusion we have reached is that total or consumer welfare is maximized through conduct by producers that is directed at serving or influencing the needs of consumers. Therefore, we need not invoke traditional concepts of total or consumer welfare in our proposed rule - and we do not do so.

In the following section we state our proposed model law. Then, we apply our proposed law to the facts in a number of decided cases. In doing so we endeavour to illustrate how a rule proscribing rent seeking by all firms articulates with greater precision the distinction between competitive conduct and socially undesirable market conduct associated with dominance.

A Proposal for a Model Law

The conclusion that must be drawn from our discussion to this point is that the distinction between competition and rent seeking is to be found in the purpose behind the market conduct. Our attempts to articulate, with greater precision, the socially undesirable market conduct associated with market dominance show that it is not possible to express the dichotomy between competitive and anticompetitive behaviour in objective terms. There is no conduct that will be socially undesirable irrespective of purpose. Conduct which
results in an increase in concentration is not necessarily anticompetitive because it may be the outcome of the very process of competition which such laws are intended to promote. Conduct which damages or excludes rivals falls into the same category. An outcome of exclusion per se is insufficient to characterize socially undesirable market conduct associated with dominance. The fact is that much competitive conduct has an "exclusionary" function. This is a difficulty that was well articulated by the High Court in Australia in Queensland Wire237 in the following way

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Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to "injure" each other in this way. This competition has never been a tort...and these injuries are the inevitable consequence of the competition s.46 is designed to foster238.
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So we are drawn to purpose as the key to articulating the dichotomy.

However, the fact that successful competition involves exclusion of rivals means that there will always be a predatory element to the conduct of firms in the market place, competitive or otherwise239. Competition itself may manifest a hostile intent. As we have seen, the dynamic of the competitive process involves rivals striving to secure relative freedom from competitive constraint - or, in other words, to secure dominance. The fact that a firm is motivated by a desire to damage its competitor is consistent with both competitive and anticompetitive behaviour. The result is that any regulation must focus

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237 Supra, note 23.

238 Ibid. at 191; see also, Easterbrook, supra, note 13 at 973.

239 Ibid. at 191.
upon the purpose of the actor, but it must go beyond a bare hostile intent enquiry\textsuperscript{240}.

As a result, not surprisingly, the trend in the regulation of market conduct associated with dominance in Australia, Canada, New Zealand and the United States has been to define that conduct which is unlawful by reference to purpose. The precise nature of the unlawful purpose is expressed in a number of different ways.

The Canadian law uses the following phrases in defining the term "anti-competitive act"\textsuperscript{241} (the operative term in the substantive provision which proscribes the practice of anti-competitive acts by dominant firms\textsuperscript{242}): "the purpose of impeding or preventing...entry into, or expansion in, a market"; "to discipline or eliminate a competitor"; and "with the object of withholding the facilities or resources from a market".

In Australia, the relevant law provides that a dominant firm shall not take advantage of its power

\[ ... \text{for the purpose of -} \]

\begin{itemize}
  \item[(a)] eliminating or substantially damaging a competitor...;
  \item[(b)] preventing the entry of a person into... any...market; or
  \item[(c)] deterring or preventing a person from engaging in competitive conduct...\textsuperscript{243}
\end{itemize}

The New Zealand law has a similar structure and provides that a dominant firm shall not use its dominant position

\[ ... \text{for the purpose of -} \]

\textsuperscript{240} The courts have rejected the use of hostile intent standards in recent cases; see, \textit{Aspen, supra}, note 210 at 2857; \textit{Barry Wright Corp. v. I.T.T. Grinnell Corp.} 724 F.2d 227 (1st Cir. 1983) at 232; \textit{Queensland Wire, supra}, note 23 at 190-1 & 149-5; and \textit{Union Shipping, supra}, note 30 at 707-9.

\textsuperscript{241} s.78 of the Competition Act.

\textsuperscript{242} s.79(1) of the Competition Act.

\textsuperscript{243} s.46 of the Trade Practices Act.
(a) restricting the entry of a person into any market;
(b) preventing or deterring any person from engaging in competitive conduct...; or
(c) eliminating any person from any market²⁴⁴.

In the United States, the recent monopolization cases have been decided by reference to the purpose of the conduct. In *Kodak* the Supreme Court held that Kodak had acted "in furtherance of a purpose to monopolize"²⁴⁵. In *Aspen*²⁴⁶, the Supreme Court framed its enquiry in terms of an efficiency purpose. The question which the Supreme Court posed was, in essence, whether the conduct of the defendant, Aspen Skiing, was consistent with an efficient purpose or whether its purpose was exclusionary²⁴⁷.

However, there is much ambiguity in such provisions insofar as they attempt to express the difference between competitive and unlawful conduct in terms of purpose. All the purposes described are equally consistent with competitive behaviour which, as we have discussed in previous chapters, may restrict entry, deter competitive conduct or eliminate a person from a market. As a result, the courts have developed a necessary gloss upon the provisions themselves in order to sharpen the distinction. It involves enquiring whether the conduct in question is atypical of that which would be expected in a competitive market. The notion of characteristically competitive behaviour has been expressed by Kaysen and Turner²⁴⁸ as follows:

A firm possesses market power when it can behave persistently in a manner different from the behaviour that a competitive

²⁴⁴ s.36 of the Commerce Act.
²⁴⁵ *Supra*, note 19.
²⁴⁶ *Supra*, note 210.
²⁴⁷ *Ibid*.
market would enforce on a firm facing otherwise similar cost and demand conditions\textsuperscript{249}.

It is a concept that was adopted by the Australian High Court in \textit{Queensland Wire}\textsuperscript{250}. A similar idea has been stated by the courts in the United States\textsuperscript{251}. It also finds expression in the decisions of the courts of the European Community, the classic statement being in \textit{Re Continental Can Co.}\textsuperscript{252}

Undertakings are in a dominant position when they have the power to behave independently, which puts them in a position to act without taking into account their competitors, purchasers or suppliers. That is the position when, because of their share of the market, or of their share of the market combined with the availability of technical knowledge, raw materials or capital, they have the power to determine prices or to control production or distribution for a significant part of the products in question\textsuperscript{253}.

The notion is that anticompetitive conduct may be identified by comparing the conduct of the dominant firm with the conduct that may be expected in a competitive market. In essence the court asks whether the conduct which is alleged to be unlawful would be rational for a competitive firm.

In theory, it is a distinction which has validity. A refusal to supply a large and financially sound customer on commercially attractive terms as to price would be irrational for a competitive firm. Therefore, it may be concluded in the absence of other evidence

\textsuperscript{249} \textit{Ibid.} at 75.

\textsuperscript{250} \textit{Supra}, note 23 at 200.

\textsuperscript{251} In \textit{Telex Corporation v. I.B.M.} 510 F.2d 894, the court held that a dominant firm may engage in practices that could be performed by any firm regardless of market share and it would then not be engaging in the practice of monopolization.

\textsuperscript{252} [1972] 11 C.M.L.R. D11.

\textsuperscript{253} \textit{Ibid.} at D27.
that such conduct is likely to have an exclusionary, and not a competitive, purpose.

However, there are problems with such an approach. Competition must be understood as a dynamic concept which includes periodic dominance. Socially desirable market conduct is not limited to that which might be associated with atomistic markets in which there are numerous competitors all with access to the same technology selling relatively identical products. Once "imperfect competition" is recognized as being an inherent part of the way markets increase efficiency it is far more difficult to identify that conduct which is atypical of a competitive firm. For example, exclusive dealing would be irrational in a highly competitive market, but as has been emphasized in the recent debate, exclusive dealing may serve a number of pro-competitive purposes.

Also, the effect of such an approach is to require the defendant to justify its conduct. This is an important consideration, the significance of which has been well captured by Easterbrook in the following comment:

This means that the plaintiff wins whenever the defendant does not know or cannot explain the true function of its conduct. In business, the only thought may be to make as much money as possible, and entrepreneurs often flounder from one practice to another trying to find one that works. When they do, they

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254 This was precisely the approach of the High Court in *Queensland Wire, supra*, note 23 at 202. Dawson J. stated at 202 that the refusal of B.H.P. to supply Queensland Wire was "made possible [for which one might read logical] only by the absence of competitive conditions". Mason C.J. & Wilson J., in a joint judgment, at 192 "It is only by virtue of its control of the market and the absence of other suppliers that B.H.P. can afford, in a commercial sense, to withhold [supply]...from the appellant". Toohey J. stated, at 216 "The only reason why B.H.P. is able to withhold Y-bar (while at the same time supplying all other products from its rolling mills) is that it has no other competitor in the steel product market who can supply Y-bar".

255 See above, c.3.

may not know why it works, whether because of efficiency or exclusion. They only know *that* it works. If they know why it works, they may be unable to articulate the reason to their lawyers - because they are not skilled in the legal and economic jargon in which such "business justifications" must be presented in court, or perhaps because their lawyers cannot understand (or translate for a jury) what they have been told\textsuperscript{257}.

Further, rivalrous conduct in the marketplace is often ambiguous. Discounting may be competitive or predatory\textsuperscript{258}. Advertising may be competitive or exclusionary\textsuperscript{259}. In many cases the real difficulty is deciding whether the conduct is characteristic of that which would be adopted by a rational competitive firm. As a result, to a considerable degree, the test begs the question. What was it about the refusal to supply referred to above that differentiated it from a refusal to supply by a seller subject to competition? What makes a lease only policy by one firm rational competitive conduct and "monopolization" by another?\textsuperscript{260} When are logo and advertising discounts and exclusive supply contracts the expression of competitive behaviour and when are they anti-competitive acts?\textsuperscript{261} When is the simultaneous release of a new film with an innovative new camera part of a competitive marketing strategy and when is it exclusionary?\textsuperscript{262} When is a policy of exclusive dealerships an outcome of a desire to ensure dealers are competitively promoting a manufacturer's product in the market place and when is it an abuse of a dominant

\textsuperscript{257} Supra, note 13 at 975.

\textsuperscript{258} McFetridge, *supra*, note 220.

\textsuperscript{259} Hay & Morris, *supra*, note 4 c.5.


\textsuperscript{261} NutraSweet, *supra*, note 8.

\textsuperscript{262} Kodak, *supra*, note 19.
position? When is a refusal to continue a cooperative marketing strategy predatory? When is the leasing of premises about to be leased by a new entrant to the market just part of ordinary business and when is it unlawful?

These are the questions which the courts face. It is no answer to say "when the context is such that the conduct is not rational for a competitive firm". That is simply to state the issue, not to advance its resolution. In each of the above examples, drawn from actual decisions which have provoked comment, the court lacked a rule which articulated with any precision the distinction between competitive and anticompetitive behaviour. In short, the existing laws as interpreted by the courts make no specific statement of the nature of the purpose that identifies with precision the socially undesirable market conduct.

Against that background, we now turn to our proposed rule. It is based upon the dichotomy between rent seeking and competition we have articulated in previous chapters. We contend that, in each of the examples referred to above, our rule would have focused the issue in the proceeding to a significantly greater degree than the existing purpose provisions - even with the gloss that has been added by the courts. After stating our proposed law we will consider its application to the factual context in four decided cases to illustrate both the often superfluous nature of enquiries as to market definition and market power and the way such a rule assists in the identification of the socially undesirable market conduct associated with dominance.

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The Proposed Law

In the formulation of our proposed law we adopt the term "exclusionary conduct" instead of rent seeking. We do so on the basis that it is more likely to be understood by a wider audience. To this point we have avoided the term, for the most part, because it is often used in an imprecise way as an antonym for competition. However, now that we have established precisely how we contend the antithesis of competition should be expressed in the context of market dominance, we adopt the more common expression. In doing so, we intend our definition of exclusionary conduct to be synonymous with the concept of rent seeking which we have used throughout.

Our law begins with a short statement of the conduct to be proscribed the substantive explanation of which we reserve for later definitional provisions.

(a) A person shall not engage in exclusionary conduct.

Consistent with our argument, the provision applies to all firms without qualification. The result is that the difficult questions of market definition and quantification of degree of "control" (usually in terms of market power), which are a substantial part of the existing dominance laws, are absent. As these two issues account for much time and expense in litigation under current dominance provisions, we argue that our approach will result

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266 E.g., Easterbrook, supra, note 13 at 973-4; and Krattenmaker, Lande & Salop, supra, note 195 at 255.

267 The proposed model law is set out in full in Appendix 3.

268 See below, c.6 - Other Advantages of Rejecting Dominance as a Basis for Regulation.
in considerable time and cost savings\textsuperscript{269}. As a public policy instrument a law which does not require proof of dominance as an element has much to commend it. It also has the advantage, as a result, of removing the potential for such laws to be used as a means of rent seeking in themselves in those jurisdictions which permit private actions\textsuperscript{270}.

Nevertheless, we expect that dominance may remain relevant in actions brought under the proposed law in one respect. As we observed in the previous chapter, an existing position of dominance has a strategic role both as a motive for, and facilitator of, certain rent seeking practices. An applicant\textsuperscript{271} under the proposed law may choose to reinforce an argument that certain conduct is less likely to be ordinary competitive conduct (an issue that will arise under the definitional provisions set out below) because the respondent enjoys an existing dominant position. However, the choice will be an evidentiary one for the applicant, in contrast to the existing laws which oblige an applicant to prove dominance as an element of every alleged contravention\textsuperscript{272}. Further, we contend that the weight which a court will afford such evidence will reflect the fact that dominance will motivate both competitive and exclusionary conduct, a factor discussed in detail below.

The next two provisions are the key to our proposal. The first, defines exclusionary conduct. As it does so by including a proviso which excludes competitive conduct, the

\textsuperscript{269} Although our approach will result in all market conduct (not just the conduct of dominant firms) being subject to scrutiny, we contend that cost savings will still result due to the lack of emphasis upon the time consuming and difficult issues of market definition and market power.

\textsuperscript{270} See above, text relating to note 220 and authorities cited therein; and Bork, supra, note 3 at 347-8.

\textsuperscript{271} Under existing laws the applicant may be a public official or an aggrieved party or either, depending upon the jurisdiction. Private actions are relatively frequent in Australia, New Zealand and the United States, but not in Canada and Europe under the existing dominance laws.

\textsuperscript{272} s.2 of the Sherman Act is the only exception. It seems that "monopolization" may be engaged in by non-dominant firms.
second provision defines that term. Taken together, the two definitions express the
distinction between rent seeking on the one hand and innovation and imitation on the
other, which has been the thrust of our thesis. As articulated in the opening to this chapter,
they focus upon the issue whether the conduct is part of the person’s competitive efforts
to serve the demands of customers (including attempts to influence those demands) or part
of an effort to prevent other firms from doing so.

(b) In this section, exclusionary conduct means market conduct, other than
competitive conduct, which prevents, or is likely to prevent, directly or indirectly,
any person from engaging in market conduct necessary in order to
(i) supply a product or products demanded by a customer or customers; or
(ii) influence the demand of a customer or customers for a product or
products.

(c) In this section, competitive conduct means conduct which has the substantial
purpose of enabling the person engaged in the conduct to
(i) supply a product or products demanded by a customer or customers; or
(ii) influence the demand of a customer or customers for a product or
products.

(d) In this section, prevent includes substantially restrict or hinder.

The qualification to paragraph (b) excluding "competitive conduct" is necessary
because the definition would otherwise encompass much competitive conduct. It is unnecessary to include a purpose element in paragraph (b) as it is expressed in paragraph (c). To the extent that exclusionary conduct may be motivated by factors entirely extraneous to commercial considerations, such as religious or political beliefs, a defence provision is proposed to ensure that the economic regulation does not incidently proscribe the general freedoms which people have to do business with whomsoever they choose for whatever reason they choose. As such motivations are likely to be peculiarly within the knowledge of the actor, and often not readily apparent from the conduct itself (taken in its market context), we have formulated the provision as a defence instead of an exclusion to the substantive provisions. It is as follows.

\[(e) \quad \text{It shall be a defence to any proceedings under this section if the person is shown to have acted for a purpose other than a commercial purpose.}\]

\[(f) \quad \text{For the purpose of this section, a person shall be deemed to have acted for a commercial purpose if the person has acted for the purpose of increasing the profitability, or reducing the losses, of any business.}\]

It is then necessary to deal with the evidence that may be used to prove purpose. To what extent does the competitive purpose have to be the only purpose in order for the proviso to paragraph (b) to apply? To what degree does the non-commercial purpose in paragraph (e) have to be the sole purpose for the exclusionary conduct? Is the standard objective or subjective? In order to deal with these issues we propose the following
provisions based upon the existing dominance laws in Australia and New Zealand

(g) Without in any way limiting the manner in which the purpose of a person may be established, a person may be taken to have acted for a purpose referred to in this section notwithstanding that after all the evidence has been considered the existence of that purpose is ascertainable only by inference from the conduct of that person or any other person or from other relevant circumstances.

(h) For the purposes of this section, a person shall be deemed to act or have acted for a particular purpose if

(i) the person acts or acted for purposes that included or include that purpose; and

(ii) that purpose is, or was, a substantial purpose.

The effect is to require the court to reach a conclusion as to the substantial purpose motivating the conduct in each case. Also, although purpose is a subjective concept, the provision allows for proof by way of inference from surrounding circumstances. The

273 See ss. 4F & 46(7) of the Trade Practices Act and ss.2 & 36 of the Commerce Act.

274 There remains some dispute as to the relevance of subjective intent. We suggest that the reason is that most jurisdictions enable proof of intent by inference (which imports an "objective" standard), although such inferences may be negated by credible evidence of subjective intent. Compare, in Canada Laidlaw, supra, note 8 at 342-3 ("Proof of subjective intention on the part of a respondent is not necessary in order to find that a practice of anticompetitive acts has occurred. Such intention is almost impossible of proof in many cases involving corporate entities unless one stumbles upon what is known as a "smoking-gun". Section 79 of the Act provides for a civil proceeding and civil remedies. In that context corporate actors and individuals are deemed to intend the effects of their actions"); and NutraSweet, supra, note 8 at 35 ("The determination of an anticompetitive act, and particularly its purpose component, is a difficult task. The Director submits that evidence of subjective intent (through verbal or written statements of personnel of the respondent) or a consideration of the act itself (the premise that a corporation can be taken to intend the necessary and
result is that an applicant may prove purpose objectively, but a defendant may lead
evidence of a subjective intent which may excuse conduct which may otherwise have been
categorized as rent seeking on the basis of inferences drawn from the facts viewed
objectively. It now falls to illustrate how the proposed law would have applied to the facts
in a number of decided cases. However, before doing so it is necessary to emphasize the
significance of our conclusion that a finding of exclusionary purpose is not preconditioned
upon a finding of dominance.

There is, in many of the recent cases, the suggestion that some power uniquely
associated with the position of dominance must be exploited for a predatory purpose to be
established. It is an integral part of our thesis that such an approach is erroneous. It falls
into error because it is based upon the misconception that only dominant firms have the
ability to exclude competition through their behaviour. As we noted in the previous
chapter, an incumbent dominant position may facilitate certain exclusionary strategies. However, two other statements are also true. First, dominant firms are likely to have
adopted superior competitive strategies which will "exclude" competition and it is easy to
confuse such strategies with rent seeking. Second, non-dominant firms may engage in rent
seeking in order to secure a position of dominance in the future. Therefore, in order to

foreseeable consequences of its actions) can be used to establish purpose. The Tribunal finds nothing objectionable in these submissions*). In Australia, a distinction is drawn between purpose to be inferred from
certain conduct and purpose to be inferred from the natural result of that conduct, the latter not being
Union Shipping, supra, note 30 at 707-8 ("Refusal to supply may be designed to eliminate, but it may be due
to poor performance or credit rating. The activity covered will not be prohibited, despite foreseen anticompetitive effects, if it arises for unrelated legitimate business reasons, without purposive pursuit of the anticompetitive purposes in themselves. If, however, the anticompetitive effects are within the defendant's purpose, questions of motive and morality become irrelevant").

* See above, c.5 - Strategic Motive and Advantage
identify conduct which is exclusionary, a criterion which goes beyond dominance is required. We have proposed a definition of rent seeking as conduct the purpose of which is to prevent others from meeting or influencing the demands of customers. The determination of such a purpose does not require an investigation of whether a firm is dominant, nor whether the firm has a power which a competitive firm does not. In this respect it is dramatically different from existing laws which are often interpreted in ways which suggest that the offending anti-competitive conduct must involve the exercise of a power unique to dominant firms.

Two recent examples illustrate the point we are making. In 1980 the state of the interpretation of s.2 of the Sherman Act was reviewed in *Kodak*276. Chief Judge Kaufman summarized the "fundamental doctrines" of s.2 in the following terms

...there is little argument over the principle that existence of monopoly power - "the power to control prices or exclude competition" ..."is the primary requisite to a finding of monopolization."

If a finding of monopoly power were all that were necessary to complete a violation of s.2, our task in this case would be considerably lightened. Kodak's control of the...markets clearly reached the level of a monopoly...But our enquiry into Kodak's liability cannot end there.

To understand the reason for this, one must comprehend the fundamental tension - one might almost say the paradox - that is near the heart of s.2..."The successful competitor, having been urged to compete, must not be turned upon when he wins"

The key to analysis, it must be stressed, is the concept of market power...A firm that has lawfully acquired a monopoly position is not barred from taking advantage of scale economies... These benefits are a consequence of size and not

276 *Supra*, note 19.
an exercise of power over the market...The mere possession of monopoly power does not ipso facto condemn a market participant. But, to avoid the proscriptions of s.2, the firm must refrain at all times from conduct directed at smothering competition. This doctrine has two branches. Unlawfully acquired power remains anathema even when kept dormant. And it is no less true that a firm with a legitimately achieved monopoly may not wield the resulting power to tighten its hold on the market\textsuperscript{277}.

Evident throughout the above reasoning is the court's struggle to differentiate competitive from exclusionary behaviour. Later, the Chief Judge distinguished gains that accrue to any integrated firm, regardless of its market share, from the "use of monopoly power"\textsuperscript{278}. His honour used purpose to monopolize or "smother" competition to express the qualitative difference. So, how did the court in \textit{Kodak} go about determining whether Kodak was motivated by such a purpose?

The facts were as follows. Kodak invented a new camera. At the same time it marketed a new film which could only be used with the camera. There was sufficient evidence at trial for a jury to conclude that the new film was not necessary\textsuperscript{279}. Kodak's control of the film market reached the level of a monopoly. The material question on the issue of purpose was why would Kodak develop and promote a new film for exclusive use with the new camera? On appeal, the court was unable to resolve the ambiguity as to whether the introduction of the new film was an intentional use of monopoly power in the film market to sell the new camera, or the competitive marketing of a new system of

\textsuperscript{277} \textit{Ibid.} at 272-5.

\textsuperscript{278} \textit{Ibid.} at 276.

\textsuperscript{279} \textit{Ibid.} at 285-6.
photography to the benefits of which it was entitled because "the process of innovation and invention" was the outcome of aggressive competition. It was unable to do so because its distinction between competition and monopolization involved an assessment as to whether Kodak had used its monopoly power. The ability to exclude competition was characterized as involving an exercise of the power attendant to a position of dominance. This is an error which is reflected in the following passage from the judgment:

In sum, Kodak's ability to gain a rapidly diminishing competitive advantage with the introduction of the 110 system may have been attributable to its innovation of a new system of photography and not to its monopoly power. On the other hand, we cannot dismiss the possibility that Kodak's monopoly power in other markets was at least a partial root of its ability to gain an advantage over its photofinishing competitors... We cannot resolve this ambiguity.

However, our analysis refutes the suggestion that predatory purpose is only manifested in the exercise of some power attendant to an existing position of dominance. Instead we have shown that the relevant enquiry is simply whether the purpose of the conduct was to serve the needs of customers, or to prevent others from doing so. In the factual context of Kodak, the issue becomes focused upon an assessment of whether the new film was part of a strategy to make the package of the film and the camera more desirable to customers than the new camera alone, or whether the fact that the new film was technologically unnecessary supported the inference that it was part of a rent seeking strategy. The manifestation of an exclusionary purpose does not require an existing dominant position. Difficult issues of dominance and attendant monopoly power are

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280 Ibid. at 292.

281 Ibid.

282 Ibid.
removed from the case\textsuperscript{283}.

In \textit{Queensland Wire}, the High Court in Australia also considered the argument that predatory purpose will be evidenced by conduct which is uniquely possible for a dominant firm. The case concerned the refusal by B.H.P. (Australia’s largest steel producer) to supply \textit{Queensland Wire} ("Q.W.I.") with Y-bar - a product manufactured in B.H.P.’s steel mills. Y-bar was used exclusively for the production of "star pickets" which, in turn, were used in fencing. All Y-bar manufactured by B.H.P. was sold to its subsidiary which manufactured star pickets and sold fencing systems which included star pickets. Q.W.I. sold fencing systems in competition with B.H.P.’s subsidiary and purchased star pickets from its competitor. Q.W.I. wished to purchase Y-bar in order to manufacture its own star pickets.

Toohey J. summarized the argument of counsel for B.H.P., the respondent in \textit{Queensland Wire} in the following way

\begin{quote}
At the core of B.H.P.’s argument was the submission that the concept of market power means absence of constraint...[It was argued that] one can never find as a fact that a person is using or exercising, let alone taking advantage of, market power unless one finds as a fact that the conduct in which the person is engaging is something in which he would not or could not engage but for the absence of constraint. In other words, it was said that there can only be a use of market power if what the corporation does it does only because of the absence of a competitor\textsuperscript{284}.
\end{quote}

His honour’s response to the argument was to state

\begin{quote}
The only reason why B.H.P. is able to withhold Y-bar (while at the same time supplying all the other products from its rolling mills) is that it has no other competitor on the steel product market who can supply Y-bar. It has dominant power in the steel products market due to the absence of constraint. It is
\end{quote}

\textsuperscript{283} The facts reported in \textit{Kodak} do not permit an analysis based upon our approach.

\textsuperscript{284} \textit{Supra}, note 23 at 216.
exercising the power which it has when it refuses to supply Q.W.I. with Y-bar at competitive prices; it is doing so prevent the entry of Q.W.I. into the star picket market; and it has been successful in that attempt\textsuperscript{285}.

The use of the word "able" suggests that His honour accepted that the "use of market power" must involve an activity that is impossible for a firm subject to competitive constraint. However, the tenor of the passage is not that B.H.P.'s conduct was only possible for a dominant firm, but that it was only rational from the perspective of dominance. In other words, B.H.P.'s strategy would not make sense if there were competitors who would supply Y-bar to Q.W.I. What is not addressed by that observation is the fact that B.H.P. did not engage in an act which was irrational for a firm subject to competitive constraint. After all, it simply refused to supply a customer - an action that is possible for any firm and may be undertaken for any number of commercial considerations.

The facts in \textit{Queensland Wire} show that exclusionary purpose is evident in the exercise by dominant firms of abilities which any firm may exercise. Though the conduct may be rational because of the prospect of dominance, the ability to act is not attendant to the position of dominance. \textit{Queensland Wire} is an example of a case where the incumbent dominant firm had a strategic advantage, in the form of its existing investment in plant sufficient to serve the entirety of the Australian market. That advantage meant that an investment in rent seeking behaviour could preserve its position of dominance. However, B.H.P.'s dominant position may also have been preserved by competitive behaviour and a competitive strategy may also have warranted a refusal to supply Q.W.I. It is not the fact that B.H.P. was able to secure or protect dominance through refusing to

\textsuperscript{285} \textit{Ibid.}
supply Q.W.I. that established the contravention, despite the suggestion to that effect in the passages quoted from the judgment of Toohey J. quoted above. B.H.P may also have been "able", by refusing to supply Q.W.I., to achieve substantial cost savings in producing Y-bar that were dependent upon the integration of the production of Y-bar with the production of star pickets. The exercise of both "abilities" may result in, or protect, dominance. However, dominance *per se*, does not taint either action with an exclusionary or rent seeking purpose. Nor does it assist, in distinguishing between the two, to ask whether by the refusal to supply B.H.P. is "able" to remain dominant distinguish between the two. The only determining factor that refusals to supply is purpose.

Where the substantial purpose is to achieve cost savings through vertical integration the conduct is competitive (even though it may make it harder for a non-integrated competitor to be able to supply the same product at a competitive price). However, what established the contravening purpose in *Queensland Wire* was the obvious inference to be drawn from the fact that B.H.P. was refusing to supply a large and viable customer, *viz.* its purpose was not to serve customers needs, but rather to prevent Q.W.I. from doing so. It was an inference that was reinforced by the absence of any competitive explanation for B.H.P.'s actions. The evidence of dominance was equivocal when it came to the task of differentiating between competitive and exclusionary behaviour. Dominance was not the means, it was the motive - and an ambiguous motive at that. The prospect of dominance motivates competitive strategies which also exclude competitors. As illustrated by the hypothetical example of vertical integration listed above, those competitive strategies may include a refusal to supply. Proving the existence of dominance does not advance the resolution of the issue whether the conduct is competitive or anticompetitive. It does not
show whether B.H.P. acted simply in order to prevent Q.W.I. from supplying star pickets as its competitor, or whether B.H.P. acted because vertical integration was essential to its endeavours to supply customers with a timely product as cheaply as possible. The only facts which established that distinction were those which evidenced the purpose for which B.H.P. acted.

The finding implicit in the decision of the High Court in Queensland Wire was that the only purpose for which B.H.P. acted was to exclude Q.W.I. The determination of the case did not require a finding as to the relevant market or the degree of power which B.H.P. had in that market. Certainly, it was material to consider whether there was any other product that may have been purchased by Q.W.I. as an alternative to that which was supplied by B.H.P., but that fact did not involve a determination of market definition or market power. The other relevant evidence concerned what was necessary for B.H.P. to supply or influence the demands of its customers. If integration of the manufacture of Y-bar and star pickets could not be explained as a necessary part of the way that B.H.P. meets or influences its customers requirements as cost effectively as possible, the inference is that either it is acting for the purpose of preventing Q.W.I. from competing, or it is acting for a non-commercial purpose. In the latter case B.H.P. could lead evidence of the fact, for example, that it disapproves of Q.W.I.'s exploitation of labour in a foreign market and that its refusal to supply is an expression of that disapproval which, if accepted, would negate the inference that its purpose was exclusionary.

A proper consideration of the facts in Queensland Wire shows that market structure could not have been the basis for the court's decision on the question of purpose. Market structure is ambiguous. It explains both successful competitive behaviour and exclusionary
behaviour. It is only through a consideration of the evidence of purpose motivating the conduct alleged to be offensive (both direct and inferential) that competitive behaviour can be distinguished from anticompetitive behaviour. Because market structure is ambiguous, it can never be used to resolve the issue of purpose. Dominance will be the reason why any firm acts. An existing position of dominance may even be part of the reason why the firm is able to act. But it will be purpose alone that differentiates competitive from exclusionary conduct.

To summarize, dominance is relevant to purpose in two respects. First, the prospect of dominance motivates rent seeking. However, it also motivates competitive behaviour. Second, a position of dominance may facilitate rent seeking. However, the only fact that will invariably distinguish a use of a dominant position for rent seeking from competitive conduct by a dominant firm is the purpose for which the dominant firm acts. Further, the purpose of the actor may be discerned without reference to whether the actor is dominant. Indeed reference to dominance is likely to result in confusion between successful competitive strategies and rent seeking, because both will be directed at achieving dominance. Therefore, although proof that conduct is unlikely to create, protect or

286 The alternative is to focus upon the effect of conduct upon competitors or total welfare. The problem with such an approach is that there is nothing to differentiate the effect of successful competition and rent seeking from the effect of rent seeking upon competitors. Both threaten the viability of competitors. In the case of successful competition it is a threat that is inherent in the efficiency of the process of competition. In the case of rent seeking it is a threat that entrenches inefficiency. However, to measure the effect of an action in the market place in order to determine whether it is "efficient" or "inefficient" is generally acknowledged as being beyond the capability of existing economic analysis; see H. Hovencamp, "The Measurement of Market Power: Policy and Science" in F. Mathewson, M. Trebilcock & M. Walker, eds., The Law and Economics of Competition Policy (Vancouver: The Fraser Institute, 1990) 43; and Moschel, W. "Antitrust and Economic Analysis of Law (1984) J. of Inst. & Theo. Econ. 154 at 169 ("Up to the present, propositions as to the average effects on efficiency in merger cases have been - given the measurement and evaluation incertitudes - anything but reliable, and the record of prediction on an individual case basis has been, as Fisher and Lande point out correctly, 'shockingly poor'. There are great doubts as to whether such methods - in the actual state of knowledge - could meet the standard of proof required in judicial proceedings and could be handled by courts in a predictable manner"); and Fisher & Lande, supra, note 104.
enhance a dominant position will refute an inference that the motivating purpose for the conduct is exclusionary, the inverse is not true.

Therefore, our proposed law makes purpose the only basis for liability. There remains the practical issue whether it is possible to establish the purposes referred to in our proposed law or whether the theoretical analysis raises practical difficulties in the courtroom. In the next section we illustrate, by reference to decided cases, how readily such evidence may be adduced and weighed in order to resolve the issue of purpose. We also explore the validity of the conclusions expressed above.

Four Applications of the Model Law

We will consider the application of our proposed law to three recent cases and one celebrated case of the past - the first from Australia, Taprobane Tours (W.A.) Pty Ltd v. Singapore Airlines Limited287; the second, NutraSweet, a Canadian case; the third, Aspen, a United States monopolization case that was finally decided by the Supreme Court; and the fourth, United Shoe Machinery, a United States case in which the distinctions between exclusion through successful competition and exclusion through "monopolization" were considered in a factual context that was reported in some detail in the reasons for decision.

Taprobane

Taprobane illustrates how the preoccupation with market definition and market power under the existing law, which requires proof of dominance as an element, not only

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consumes enormous amounts of court time\textsuperscript{288}, but also directs the attention of the court away from an examination of the market conduct alleged to be offensive. The case concerned the marketing of wholesale package tours from Australia to the Maldives.

In the period 1984 to 1986 Taprobane Tours marketed wholesale package tours to the Maldives. During that period discount airline services for travel between Australia and the Maldives were supplied by Singapore Airlines to Taprobane Tours and other wholesalers of Maldivian package tours. Singapore Airlines was the only supplier of such airline services, there being no feasible or economic alternative for travel by air to the Maldives for Australian tourists\textsuperscript{289}. Taprobane Tours and other wholesalers incorporated the airline services with accommodation, airport transfers and land tours to form package tours which were sold as a bundled product to retailers. From March, 1986 Singapore Airlines commenced selling its own wholesale package tours to the Maldives in competition with Taprobane Tours and other wholesalers. In 1987 Singapore Airlines refused to continue the supply of discount airline services to Taprobane Tours. On 6 November, 1987 Taprobane Tours brought an action in the Federal Court against Singapore Airlines alleging that Singapore Airlines had contravened s.46 of the Trade Practices Act and claiming damages\textsuperscript{290}.

A significant issue in \textit{Taprobane} was whether Singapore Airlines had a substantial degree of power in a market. Although Taprobane Tours was successful at first instance

\textsuperscript{288} The considerable court time spent in considering issues of market definition and market power was the subject of comment by the trial judge in awarding costs of the trial. His honour observed that the considerable amount of court time expended in addressing such issues was necessary for the applicant to establish the dominance of Singapore Airlines; unreported decision of Lee J. delivered 4 September, 1990.

\textsuperscript{289} \textit{Supra}, note 287 at 658.

\textsuperscript{290} The report of the decision at first instance in \textit{Taprobane} is at (1990) 96 A.L.R. 405.
on this issue, an appeal by Singapore Airlines led to the decision being reversed on the ground that the relevant market encompassed package tours to many island destinations, a market in which many airlines competed in the provision of airline services. The result was that the appeal court found it unnecessary to explore the purpose for the conduct. The appeal was allowed solely on the question of market definition. That is, because Singapore Airlines was not a dominant firm it had not contravened the relevant statutory provision.

However, we have concluded that the material issue from the perspective of total welfare is to determine whether the conduct was competitive or rent seeking in purpose. In *Taprobane*, on the issue of purpose, the trial judge found that Taprobane Tours was "an efficient operator with a competitive product and that it conducted its business on proper financial terms"\(^{291}\). There was no evidence to suggest that there was any financial risk to Singapore Airlines associated with Taprobane Tours continued operation as a wholesaler and it was conceded by Singapore Airlines that there had been no complaints against Taprobane Tours in the history of its operation of tours to the Maldives\(^{292}\). After the refusal to supply Taprobane Tours, Singapore Airlines offered to sell airline tickets to Taprobane Tours, but was shown to have imposed a discriminatory fare. No commercial explanation for the fare was forthcoming\(^{293}\).

His honour also found "on the totality of the evidence" that Singapore Airlines had acted "to rationalize or redefine the operations of the wholesalers...by restricting the ability

\(^{291}\) *Ibid* at 418.

\(^{292}\) *Ibid*.

\(^{293}\) Of course, the burden of proof remained upon Taprobane Tours throughout. But, once the circumstances of the refusal to supply had been established, inferences could be drawn in the absence of any commercial explanation from Singapore Airlines.
of Taprobane to engage in competitive conduct" 294. Taprobane Tours was Singapore Airlines closest competitor in the market place offering packages that were very similar to those offered by Singapore Airlines own wholesaling operations. Although not expressly quoted in the reasons for decision of the trial judge, the evidence at trial included an internal report by Singapore Airlines' marketing services manager which recommended the discontinuance of a number of wholesalers, including Taprobane Tours, on the basis that they "conflicted" with the market position of Singapore Airlines own wholesale operations and the continuance of other wholesalers because there was "no conflict" as they served "specialist" markets. Also, other documents showed that Singapore Airlines' wholesale sales targets for package tours to the Maldive Islands could not have been achieved without the elimination of Taprobane Tours from the market.

All the evidence referred to above was able to be adduced by Taprobane Tours without great difficulty. Taken together it gave rise to an inference that Singapore Airlines had acted to improve its profitability by excluding Taprobane Tours rather than attempting to improve its service of customers. Under our proposed law such evidence would establish that Singapore Airlines had engaged in exclusionary conduct that was not competitive conduct (that is, it was not conduct directed at serving the needs of customers or influencing customer demand). Such evidence would meet the evidentiary burden without requiring the court to reach any conclusion as to the relevant market or the degree of market power of Singapore Airlines. Of course, the inference as to exclusionary purpose is derived in part from an appraisal of how close a competitive relationship existed between Taprobane Tours and Singapore Airlines. However, that conclusion could be reached by considering the

294 Ibid. at 419.
products supplied by the two parties, the geographical area in which each made sales, and the extent to which customers switched between the two. Absent is the need to adduce such evidence for all possible competitors in the market however defined (evidence that is required under existing laws which require proof of a dominant position).

Of course, one can conceive of competitive explanations for Singapore Airlines' decision not to supply a particular wholesaler notwithstanding its commercial viability in the past. One hypothesis may be that Singapore Airlines decided to make a strategic change to in-house marketing on the basis that it could train its own staff more cheaply than it could train agents, and could ensure that its staff provided a highly specialized level of service that suited the multi-lingual traffic to the Maldives or customized tours demanded by most travellers. Had such a defence been raised to explain the inferences that would otherwise be drawn from the available evidence, then Taprobane Tours in turn may have adduced evidence that it was given no opportunity to demonstrate the ability of its staff to provide multi-lingual, customized services to prospective customers, or that it had such capability and that it was known to Singapore Airlines. Inferences may be drawn from the fact that Singapore Airlines could produce no marketing report reflecting such a policy.

We see that the focus of the inquiry becomes the discernment of the purpose of Singapore Airlines from the surrounding circumstances. Certainly, in Taprobane there was no necessity for the court to undertake a market analysis and make findings as to the relevant market or the degree of market power presently held by Singapore Airlines in order to draw inferences that Singapore Airlines conduct was motivated by its desire to protect its market power by means other than serving or influencing customers.

In Taprobane Singapore Airlines argued that its actions had been motivated by two
purposes; improving its profitability by ensuring that it dealt only with established operators who might be expected to provide regular and reliable custom to Singapore Airlines, and avoiding financial loss. Both "explanations" were found to be without foundation on the evidence - and could be addressed without resort to issues of market definition and market power.

The problem with the existing Australian law is that it is preconditioned upon a finding as to market power, an issue about which there may be much conjecture. The fact is that the clear exclusionary purpose of many actions by firms is excused on the basis that the firm is not "dominant". The irony is not only that such an approach excuses much rent seeking behaviour on the erroneous basis that it is only of concern when engaged in by a dominant firm, but also that it ignores the fact that it is the prospect of future, continuing or improved dominance that motivates all market conduct. Aside from cases where markets approach the theoretical model of perfect competition (at least for so long as there is such perfect competition), in which case dominance is an impossibility, all market behaviour is driven by the possibility of dominance. The real issue is whether the driving force of dominance is inducing exclusionary (or rent seeking) conduct instead of encouraging competition. It is a far more focused enquiry to ask why Singapore Airlines refused to supply Taprobane Tours, than to first ask whether Singapore Airlines was a dominant firm. Indeed, within a dynamic marketplace, establishing dominance at any point

295 The trial judge's approach was to conclude that the relevant market was the market for the supply of airline services to the Maldives because, as the evidence showed, Singapore Airlines had the ability to promote or retard a wholesaler in the wholesale tour market without fear that the airline would be able to incorporate the services of a competing airline. The Full Court disagreed and found that because customers could substitute a holiday to another destination for the holiday to the Maldives, the relevant market was much broader. Of course, both factors influence the market decisions of buyers and sellers of airline services. No firm conclusion may be reached.
in time may be as elusive (and pointless) as attempting to pick up quicksilver between one's fingers. It is far more to the point, and less time consuming to simply ask why did the firm act the way it did!

The point could not be better illustrated by another recent Australian case. In Papersave, one of the directors of Papersave discovered that one of its former employees, Williams, was about to acquire a lease of certain premises in order to establish a business in competition with Papersave. The director then attempted to lease the same premises for Papersave. An injunction was sought. It was found that a substantial purpose for the director seeking to lease the premises was to frustrate the new entry by Williams. However, it was found at trial and upheld on appeal, that the actions of Papersave did not amount to a use of market power. Therefore, Papersave had not contravened the dominance law.

As we have argued above, there need be no connection between the position of dominance and socially undesirable market conduct. Papersave illustrates perfectly the situation where dominance motivates, rather than facilitates, rent seeking conduct. There need be no special power attendant to the dominant position that is exploited. Papersave would have contravened our proposed law because the sole purpose of its conduct was to prevent Williams from supplying Papersave's customers. However, its socially undesirable market conduct would not be proscribed by existing dominance laws.

The evidence necessary to reach a conclusion as to whether Papersave was motivated

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296 Supra, note 265.


298 Supra, note 265.
by an exclusionary purpose is amply illustrated by the trial judge’s reasons which report in detail the evidence adduced at trial\textsuperscript{299}. Papersave was looking for new premises in a rather general way. Its existing premises were 100,000 square feet, of which at least 25,000 square feet was fully occupied. The premises to be leased by Williams were only 15,000 square feet. However, the director of Papersave who had offered to lease the premises desired by Williams, did so urgently, "more or less on the spot", and there was no explanation as to why the decision was made with such haste\textsuperscript{300}. No estate agent had been engaged by Papersave to seek out desirable premises. No other premises had been inspected. The premises were smaller than Papersave’s current requirements. Material witnesses who might have explained the urgency of the decision to lease the premises were not called. As a result the trial judge concluded that a substantial purpose of Papersave’s actions was to frustrate Williams entry into the market. It was a finding that was not challenged by Papersave on appeal.

\textbf{NutraSweet}

In \textit{NutraSweet}, one of the first cases decided under the new dominance law in Canada’s relatively recent overhaul of its competition law, there was extensive consideration of issues of market definition and market power\textsuperscript{301}. The Director of Investigation and Research contended that NutraSweet had engaged in a series of acts which constituted an abuse of its dominant position in the Canadian market for artificial sweeteners. NutraSweet

\begin{itemize}
\item \textsuperscript{299} \textit{Supra}, note 297 at 48,517 to 48,522.
\item \textsuperscript{300} \textit{Ibid.} at 48,524.
\item \textsuperscript{301} The consideration of the evidence on the issues of market definition and market power occupies the first 31 pages of the reported decision.
\end{itemize}
had secured certain patents for the production of aspartame. During the currency of those patents it had embarked upon a "branded ingredient strategy" which involved promoting a brand - "NutraSweet" - for an industrial product - aspartame - directly to consumers. It was an innovative strategy. In order to implement it NutraSweet advertised its branded product directly to consumers. At the same time it persuaded Coke and Pepsi, through certain discounts, to include its brand name on their products.

The result was that, upon the expiry of NutraSweet's patent for aspartame, an extra demand was created for NutraSweet over aspartame which may be supplied by other manufacturers. One of the principal complaints against NutraSweet was that it had used exclusive supply contracts together with rebates for displaying the NutraSweet logo on products to be sold to consumers as part of its marketing strategy. The tribunal summarized the effect of such conduct upon entry in the market for the supply of aspartame as follows

The logo and advertising discounts create an "all-or-nothing" choice for customers. In the event that customers decide that they would prefer not to use the logo for a particular product line or not to commit themselves to use it on all of that line, they are forced to purchase all of their supply from another supplier because it is too expensive to buy from NSC without the logo and advertising discounts. This means that new suppliers must become sufficiently established so that potential customers are willing to entrust all of their needs for a product line to the new supplier.

The suggested inference is that the effect of making entry difficult was the goal that motivated NutraSweet to adopt the exclusive supply contracts and advertising rebates. However, as we have argued at length, the fact that market conduct results in difficulties

\footnote{\textit{Supra}, note 8 at 41.}
for entry by prospective competitors is indeterminate. Successful competitive strategies make entry difficult. True, such outcomes may also be secured or protected by rent seeking behaviour. The question is whether the means by which NutraSweet secured its relative independence from competition was anticompetitive. The fact that NutraSweet desired a dominant position is perfectly consistent with a competitive purpose. However, the Tribunal concluded that provisions in the agreements between NutraSweet on the one hand, and Coke and Pepsi on the other, had an exclusionary purpose, and that NutraSweet had contravened the dominance provision by including them in its agreements. The particular provisions were an exclusive supply clause which required that the customer purchase all of its requirements of aspartame from NutraSweet and a trade mark display allowance clause which gave a discount for the inclusion of the NutraSweet logo on the products manufactured by buyers of aspartame.

The tribunal relied upon internal documents of NutraSweet that showed that its overall branded ingredient strategy was adopted "to prevent price from falling to the level of marginal costs of production, which tends to occur with other chemicals that are sold as commodities" and that NutraSweet was attempting to capture and keep as much market as possible\textsuperscript{303}. This evidence led the Tribunal to conclude

On the basis of this evidence and the fact that the strategy was introduced when the use patent was in force and customers did not have a choice of suppliers and marketing approaches, the tribunal is persuaded that the strategy has been and is pursued for the purpose of excluding future or existing competition and not because it is required for efficient distribution or use of the product\textsuperscript{304}.

\textsuperscript{303} Ibid. at 40.

\textsuperscript{304} Ibid.
But such a conclusion may be drawn in respect of much competitive conduct. Of course, the agreements had an exclusionary purpose. NutraSweet was not investing in trying to create a market opportunity for its competitors. It invested in a strategy designed to maximize profits. Those profits were to be secured through obtaining a relative position of dominance for as long as possible. The real question, which was not addressed by the tribunal, was whether the exclusionary purpose was part of a competitive strategy or part of an anticompetitive strategy. There was no attempt to recognize that competition may well have an exclusionary effect, and deliberately so.

This is an error which arises, we suggest, because of the emphasis under the existing law upon dominance as an element of the contravention. The result is that conduct directed at achieving a dominant position tends to be viewed in pejorative terms. It is all right for firms to have dominance "thrust upon them", but not for firms to seek after dominance. Such an approach denies the reality of the whole process of competition. The issue is not whether NutraSweet desired to achieve "exclusivity", but whether its strategy involved competitive or rent seeking conduct. So, to conclude, as the tribunal did, that NutraSweet was "obviously interested in promoting its name and mark, exclusivity in its own right, rather than exposure of its product name, is clearly at play in the contracts" does not advance the resolution of the issue.

Our approach would direct the enquiry to the resolution of the question whether the purpose of the exclusive dealing agreements was to persuade customers to buy NutraSweet products (and, ipso facto, not purchase other products manufactured with aspartame from competitors of NutraSweet) or, through means other than supplying or influencing customer needs, to make it more difficult for competitors to enter the market.
Let us return to the facts in *NutraSweet*. The strategy of attempting to convince customers that products which contained NutraSweet were more desirable than products that contained other aspartame is entirely consistent with competitive behaviour. Essential to such a strategy is the identification of products as containing NutraSweet and the promotion of NutraSweet as an integral part of the product. It involves the joint promotion, for example, of Diet Coke and NutraSweet as a combination of two desirable products. NutraSweet must secure the agreement of the manufacturers of such products to facilitate such joint advertising. It may do so by means of discounts to its customers who agree to participate in promoting the NutraSweet logo. It may seek to make its brand so popular that no consumer will want to purchase diet products that do not have NutraSweet as their sweetening ingredient. These are actions which are consistent with a competitive purpose.

However, as part of its strategy NutraSweet in fact required its customers to purchase all of their aspartame requirements from NutraSweet. This may have been to justify the investment in joint promotion. It may have been to create scale efficiencies. It may have been caused by concern that there will be free riding on NutraSweet's association with a particular product by other manufacturers of aspartame. These are all purposes that would be consistent with supplying and influencing customer demands. But, without considering these and other possibilities, the tribunal concluded that the exclusive supply contracts were anticompetitive because they were part of an overt strategy by NutraSweet to "capture and keep as much of the market as possible for NutraSweet". On the basis of that evidence alone the tribunal concluded that the purpose of the exclusive dealing

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strategy was the exclusion of future or existing competition. Again, the fact of intended exclusion (or, in other words, the fact of intended dominance) seems to have influenced the tribunal. The reality is that any competitor seeks to capture and keep as much of the market as possible. The tribunal lacked what is explicit in our proposed law, viz. a statement to distinguish such competitive purposes from rent seeking purposes. The tribunal should have considered whether the "sole supplier strategy" of NutraSweet enabled it to more effectively supply or influence demand for its product. If so, the tribunal may have inferred that such was its purpose. If not, an inference of anticompetitive behaviour may have been supported.

There was some evidence that suggested an anticompetitive purpose, but it related to the discounts for display of the NutraSweet logo. The discount was applied even though the logo was not displayed or was relatively obscure. However, the ultimate decision by the tribunal rested upon the existence of exclusive supply agreements as being evidence of an "exclusionary purpose". As discussed above, such agreements may have any number of purposes in the factual context of NutraSweet.

However, the tribunal's failure to address properly the purpose issue does not negate our argument. The tribunal's error did not arise from any difficulty in proving purpose, but rather from a failure to articulate the nature of an anticompetitive purpose and to distinguish it from a competitive purpose. Had it made the distinction there would have been a detailed consideration of the operations of NutraSweet and the necessity for exclusive contracts to maintain scale efficiency, prevent free riding or facilitate its marketing program as the case may be.

The courts are experienced in deciding whether the actions of a firm are consistent
with a particular purpose. The problem with the reasoning in NutraSweet was that the tribunal failed to articulate with sufficient precision the relevant purpose. It is an error that would not arise under our proposed law which clearly states the contravening purpose.

Aspen

Of the four ski mountains at Aspen, three are controlled by Aspen Skiing Co ("Aspen") and one by Aspen Highlands Skiing Corp ("Highlands"). From 1958 to 1977 joint tickets were offered for skiers which enabled them to use any of the four slopes. Profits from the sale of the tickets were distributed in accordance with usage of the various slopes. In 1978, Aspen decided to discontinue its participation in the joint ticket. It implemented its decision by making Highlands an offer as to a fixed allocation of profits from the sale of joint tickets which was unreasonably low and refused to consider any counterproposals by Highlands (including a proposal that the profits from the sale of the tickets be allocated on the basis of independent audits carried out by a firm such as Price Waterhouse at Highland's cost).

Highlands' subsequent attempts to introduce its own four mountain ticket by issuing vouchers for its customers to exchange for daily tickets on Aspen's mountains were frustrated by Aspen refusing to honour such tickets. Eventually, Highlands was successful in introducing a multi-mountain ticket using travellers cheques and other negotiable instruments for its customers to purchase single day tickets for Aspen mountains. However, Aspen responded by increasing its single day ticket price significantly in comparison to its own three mountain pass, which excluded skiing on Highland's slopes. There was no reference to a cost rationale for such a change in pricing practices.
It is apparent from the reports that a considerable issue at trial and before the Court of Appeals was whether Aspen had a substantial degree of power in a relevant market. Once again such issues would be irrelevant under our proposed law. The important issue, we contend, is why did Aspen refuse to continue its marketing practice of participating in the promotion of a joint ticket to all four mountains? Was it motivated by a desire to serve customer demand, or to influence customers to prefer Aspen's mountains, or was it rent seeking behaviour? Proof of dominance was not required to resolve that issue.

The strong inference from the market behaviour of Aspen is that it was pursuing a rent seeking strategy. Importantly the joint ticket had originated when all four mountains were independently controlled\textsuperscript{306}. Aspen had frustrated Highlands attempts to offer its own four mountain ticket. It did so not by offering a better price or service to customers, but by refusing to accept the commercial opportunity afforded by Highlands purchasing single day tickets from Aspen to form part of Highlands own multi-mountain ticket. Such evidence supported an inference that Aspen was engaging in exclusionary conduct. Did such conduct have a competitive explanation?

In a comment upon the decision in Aspen, Easterbrook formulates possible explanations

Consider an explanation Skiing [Aspen] might have offered for cutting Highlands out of the multi-mountain ticket. It might have said that Highlands was an inefficient "fringe" firm taking a free ride on the fact that Skiing had developed the resort's principal mountains and attracted tourists, which Highlands diverted once they were in Aspen. Highlands' mountain was

\textsuperscript{306} In a comment upon the decision in Aspen, Easterbrook, supra, note 13 at 974 argues that it was improper for the Supreme Court to draw an inference of exclusionary purpose from the fact that Aspen had simply changed a long standing practice. However, it had done more than that. It had changed a long standing practice that had been established when there was more direct competition.
below average in attractiveness; why else did it get only 13% to 18% of the business from the four-mountain ticket? The four-mountain ticket gave Highlands an opportunity to divert skiers at no marginal cost to the skiers. Skiing might believe that it was entitled to compensation for providing Highlands with a pool of ready customers and facilitating their migration to Highlands' mountain...Moreover, Skiing might have argued that economies of scale called for the use of only three rather than four mountains.

However, there was no such evidence at trial. Instead Aspen was entirely silent in its explanation of its purpose for refusing to supply Highlands, in the face of the inferences to be drawn from its willingness "to forgo daily ticket sales both to skiers who sought to exchange the coupons...and to those who would have purchased Ski Co. [Aspen] daily lift tickets from Highlands if Highlands had been permitted to purchase them in bulk." Its contention that the usage of the mountains could not be monitored was refuted by its unreasonable refusal to accept the offer of an audit paid for by Highlands and the fact that it allowed such multi-mountain tickets at other ski operations which it owned. Its argument that it wanted to dissociate itself from Highlands allegedly inferior services was refuted by the fact that customers made their own choice as to which mountain to use and the fact that "it was willing to associate with what it considered to be inferior products in other markets".

Such "purpose evidence", readily available in Aspen, would be all that would be

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307 Supra, note 210 at 975-6.

308 If there was a criticism to be made of the direction by the trial judge to the jury it was that she tended to suggest that it was for Aspen to prove that it had a legitimate business purpose for its refusal to continue the joint marketing of the four-mountain ticket - rather than clearly stating, as was the case, that it was for Highlands to establish on the preponderance of the evidence (and in the absence of evidence to the contrary) that Aspen had been motivated by an exclusionary purpose. In fact the direction was in the following terms "In other words, if there were legitimate business reasons for the refusal, then the defendant, even if he is found to possess monopoly power in a relevant market has not violated the law", Ibid. at 477.

309 Ibid. at 484.
required to resolve the case under our proposed law. Detailed and difficult issues of market definition and market power would not need to be considered at all. Moreover, the purpose enquiry would be more sharply focused. The Supreme Court expressed the purpose enquiry in the following way:

The question whether Ski Co.'s [Aspen's] conduct may be properly characterized as exclusionary cannot be answered by simply considering its effect on Highlands. In addition, it is relevant to consider whether it has impaired competition in an unnecessarily restrictive way. If a firm has been "attempting to exclude rivals on some basis other than efficiency," it is fair to characterize its behaviour as predatory. It is, accordingly appropriate to examine the effect of the challenged pattern of conduct on consumers, on Ski Co.'s smaller rival, and on Ski Co. itself.\footnote{310}\footnote{Ibid. at 482.}

The court went on to conclude that "consumers were adversely affected by the elimination of the 4-area ticket". Such conclusions are inherently ambiguous. Some consumers may be adversely affected by what is otherwise a competitive strategy. It is not the fact that some consumers are adversely affected, but the fact that there is no apparent benefit to any consumer that motivated the refusal to cooperate in joint marketing, that is material. Our proposal makes it clear that what is material is whether any deleterious impact upon customers was merely incidental to an attempt to serve or influence customers generally.

The court also emphasized the fact that Highlands was damaged by Aspen's conduct because its ability to compete was affected. Again such an outcome is ambiguous being entirely consistent with the implementation of a competitive strategy. Our proposed law reorientates the enquiry to focus upon the material issue in terms of total welfare - was the purpose of the act to serve or influence customers. Our provision makes it clear that the

\footnote{310} Ibid. at 482.
only offensive conduct is that which prevents a firm from competing without being motivated by the purpose of serving or influencing customers. It assumes that all market rivalry is about damaging competitors and then identifies, by an express statement of purpose, that sub-set of market conduct which is socially undesirable. The problem with many of the descriptions by the Supreme Court in Aspen as to why Aspen’s refusal to cooperate in the marketing of a four-mountain ticket was "monopolization" was that many of its formulations describe "competitive" conduct. However, the evidence adduced in Aspen does illustrate that our proposal would enable the resolution of the issue without resort to issues of market power.

United Shoe Machinery

One of the celebrated competition law cases in the United States is United Shoe Machinery. United Shoe had achieved a position of market dominance in the business of supplying machines for the manufacture of shoes. One of its business strategies was to follow the practice of "never selling, but always leasing". Such lease-only strategies had been followed by all competitors in the industry since the American Civil War. The leases included free repair and other services. Lease costs were a low part of overall cost for shoe manufacturers, but problems with machinery had the potential to produce substantial downtime costs. Also, small operators preferred to lease machines rather than to outlay the entire cost of purchasing machinery in advance.  

311 Supra, note 260.

312 The court does not refer to such a factor expressly. However, it does refer to the fact that the lease-only policy facilitated entry into the shoe manufacturing industry; supra, note 262 at 301 & 323, and cites the relevant term in the lease, ibid. at 316.
Therefore, a system of machinery supply which guaranteed prompt and efficient repairs and required payment based upon usage was highly desired by manufacturers. United Shoe included terms in its leases which made it undesirable for a manufacturer to switch brands during the currency of any lease, provisions which required the machine to be used to capacity if work was available and leases were for long terms.

In deciding that by the use of the lease-only policy United Shoe had monopolized the market, the court observed

In one sense, the leasing system and miscellaneous activities...were natural and normal for they were..."honestly industrial"...They are the sort of activities which would be engaged in by other honourable firms\textsuperscript{313}.

Yet the court concluded that, within the factual context, the lease-only contracts were "unnatural barriers". While such conduct was lawful for many enterprises it could not be used to effect "the continuance of effective market control based in part upon such practices"\textsuperscript{314}. The court accepted that United Shoe did not have a predatory intent and that the conduct would be lawful in other circumstances, but concluded that as it was sustaining dominance through creating barriers to entry it was unlawful.

The emphasis upon structural analysis reflects the economic understanding of the time. However, the decision fails to adequately address the possibility that the barriers were the incidental outcome of competitive behaviour. The relevant passage from the judgment is as follows

They [the lease-only practices] represent something more than the use of accessible resources, the process of invention and innovation, and the employment of those techniques of

\textsuperscript{313} Ibid. at 344.

\textsuperscript{314} Ibid. at 344ff.
employment, financing, production, and distribution, which a competitive society must foster. They are contracts, arrangements, and policies which, instead of encouraging competition based upon pure merit, further the dominance of a particular firm. In this sense, they are unnatural barriers; the unnecessarily exclude actual and potential competition; they restrict a free market\textsuperscript{315}.

The distinction is between practices which encourage and discourage competition - the later constituting the creation of unnatural barriers, or monopolization. However, as our analysis has shown, the very essence of the competitive process involves discouraging competition by others. There is no altruistic character to the competitive process. The approach used by the court makes it very difficult to understand why lease-only practices create unnatural barriers and the process of invention and innovation does not\textsuperscript{316}. Leasing was a method that was preferred by customers, as was evident from its adoption by all competitors in the market. Why is leasing not "an inevitable consequence of ability" - ability to supply machinery on attractive terms?

Our response is to ask, was the lease-only policy rent seeking. Was its purpose to supply the needs of customers, or to prevent competitors from doing so? A leasing system which included all necessary repairs would seem to be highly desirable for small shoe manufacturers. The risk of possible breakdown was retained by United Shoe. The focus of attention becomes not the lease-only policy \textit{per se}, but the conditions attached to it. What does the practice reveal about the purpose of United Shoe? Why were leases for 10

\textsuperscript{315} \textit{Ibid.} at 344.

\textsuperscript{316} The distinction is all the more difficult to comprehend when one considers that the relief granted by the court included the imposition of a number of obligations upon United Shoe to licence all those who wished to use machinery protected by patents held by United Shoe, for a reasonable fee. This relief was granted despite the observation that most patents had expired and that it was relatively easy to invent around those that remained.
years? Were there substantial costs associated with moving the machinery which could be spread over 10 years if United Shoe knew that the machinery was to remain in one place for that period - leading to lower costs for the shoe manufacturers (an innovative strategy), or was the only rationale for the 10 year term to make it less likely that the manufacturer would lease a machine from a competitor (a rent seeking strategy)? Was the bundling of machine and repairs a case of United Shoe retaining the risk of breakdown (an innovative strategy), or an attempt to impose additional costs on any entrant into the industry (a rent seeking strategy)? To ask, as the court did, whether the lease-only strategy "restricts a free market" is not specific enough. The more focused enquiries raised by our model law would enable the court to make more informed and more precise distinctions between competition and unlawful rivalry.

The Issue of Predatory Pricing

We conclude our illustration of the application of our proposed law compared to existing approaches to the regulation of dominant firms by considering an issue which has led to much discussion in all jurisdictions, predatory pricing. When is a low price evidence of competitive behaviour and when does it constitute anticompetitive behaviour? Various measures have been proposed - the most famous being that developed by Areeda and Turner. However, all such measures are based upon the rationality of pricing below some calculation of cost. The argument usually proceeds as follows. Pricing below 

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317 E.g., McFetridge, supra, note 220; O.E. Williamson on Predatory Pricing II (1978-79) 88 Yale L.J. 1183; and Dunlop, McQueen & Trebilcock, supra, note 8 at 222ff.

certain costs is irrational for a firm subject to competitive constraint. Therefore, pricing below such costs is logical only for a dominant firm and when adopted by a dominant firm is likely to be predatory. The analysis is highly dependent upon the equilibrium associated with the model of perfect competition in which the process of competition is shown to push firms towards marginal cost pricing. However, our analysis has shown competition to be a dynamic process which includes the prospect of dominance. Consistent with such an analysis we would emphasize that it may be rational to price below the cost that would apply if sales were at lower volumes\textsuperscript{319} in order to achieve scale efficiency, or as an alternative to advertising to attract custom, or as part of a service to customers that assists in selling other products, or as an attempt to sell off redundant stock or generate short term cash flow\textsuperscript{320}.

As a result it is impossible to evaluate quantitatively whether a particular low pricing strategy is a desirable part of the competitive process or whether it is predatory. As has been observed elsewhere "the issue of predatory intent keeps forcing its way to centre stage"\textsuperscript{321}. However, existing attempts to accommodate the issue of intent or purpose in the formulation of a rule to identify predatory pricing are framed in terms of efficiency\textsuperscript{322}. As we have observed previously, such approaches do no more than state the general issue - namely whether the pricing strategy will increase total welfare. No basis is given for

\textsuperscript{319} Costs may also be projected to be lower due to anticipated learning improvements over time, and such anticipated savings may be factored into current prices.

\textsuperscript{320} See the analysis by the New Zealand High Court in \textit{Union Shipping}, supra, note 30 at 707-8.

\textsuperscript{321} Dunlop, McQueen & Trebilcock, \textit{supra}, note 8 at 230.

\textsuperscript{322} Bork, \textit{supra}, note 3 at 144 ("Antitrust law has never clearly defined by what it means by predation, but the concept clearly contains an element of wrongful or specific intent, of a deliberate seeking of market power through means that would not be employed in the normal course of competition"); and Dunlop, McQueen & Trebilcock, \textit{supra}, note 8 at 227.
determining whether a particular strategy is "efficient". Determinations of efficiency often require information that is extremely difficult or impossible to obtain, let alone prove in a court or tribunal setting\textsuperscript{323}. More importantly, efficiency is not a purpose that is pursued by firms. It is an outcome. A court must identify the purpose of the low price and then determine whether that purpose is competitive or predatory. In contrast, our rule would express the purpose in terms which focus the enquiry. Is the low price an attempt to serve (or influence) customer needs and tastes? Or is the low price an attempt to prevent entry by other suppliers? In the first case the pricing practice is competitive, in the second it is predatory. Of course, the cost tests would still be relevant to any determination under our proposed law. What is important is that the court is given clear direction as to the purpose that is unlawful.

Other Advantages of Rejecting Dominance as a Basis for Regulation

Requiring the proof of dominance has introduced enormous prolixity and difficulty into litigation concerning dominant firm market conduct\textsuperscript{324}. To explore the evidentiary issues raised by the concept would require many pages. Suffice to say that in all jurisdictions dominance is established by proving the "relevant market" and then determining the degree of market power which the defendant possesses in that market. An enormous amount of evidence is usually introduced in order to establish the relevant

\textsuperscript{323} \textit{Supra}, note 286.

market. The concept of a relevant market is a theoretical abstraction rather than a factual reality. Rules of evidence designed to uncover an objective truth do not lend themselves to restricting the material that is relevant to an abstract enquiry. There are difficulties in stating the role of expert economic evidence in making the determination whether a particular firm is dominant.

Under our proposal, whilst such issues may still be relevant in a particular case, they will no longer be determinative. Courts will not be required to make precise findings upon such issues in all cases. The focus will be the conduct and its purpose, rather than the structure of the market. Instead of usurping the court's role by seeking to draw conclusions about the relevant market or the degree of market power of the relevant firms, expert economic evidence would be directed at explaining market conduct that is consistent with competitive strategies or rent seeking strategies thereby removing many tensions inherent in the role of the expert economist under the existing laws. The rule which we propose reflects the exposition of economic analysis rather than the enshrining of economic theory in a legislative provision. It develops a rule that is instructed by economic theory. The courts are used to determining the purpose which has motivated a particular action. Therefore, we contend that in addition to articulating with greater precision the socially undesirable market conduct associated with dominance, our proposed law will result in substantial cost savings and greater predictability in the law.

325 Bollard & White, supra, note 32 at 50; and Brunt, Economic Evidence in Australia, ibid.

326 Ibid.

327 See above, c.5 - Strategic Motive and Advantage.
Chapter 7: Conclusion: Prometheus Unbound

We have argued that the existing regulation of dominant firms should be replaced by a law which proscribes rent seeking by all firms. Our reasoning has been as follows. First, a competitive market is desirable because it promotes total welfare. Second, the prospect of dominance is an inherent part of the dynamic of a competitive market. It follows that dominance should not be viewed in exclusively pejorative terms as it is the motive that drives welfare improving behaviour in the market place. Further, properly understood, the process of competition, though it may result in dominance, in fact operates to both build and break down dominant positions because the supra-normal profits earned by dominant firms attract strong competition. Therefore, the process of competition works against concentrations of wealth and economic power. Third, the prospect of dominance motivates both competitive behaviour (innovation and imitation) and rent seeking. Fourth, in the context of the overall dynamic, it is only rent seeking that is welfare reducing. Fifth, dominant firms have strategic motive and power to engage in rent seeking. However, all firms have the ability to engage in rent seeking and will do so where there is the likelihood of achieving dominance at a cost that is less than the value of the supra-normal profits attendant to a position of dominance to be secured through the rent seeking behaviour. Sixth, it follows that rent seeking by all firms should be proscribed. Seventh, rent seeking is to be distinguished from ordinary competition by the fact that its purpose is not to meet or influence consumer demand. Eighth, in addition to being more certain than the existing dominance laws (a characteristic has obvious welfare and fairness advantages), a law proscribing rent seeking by all firms has the advantage of not requiring a conclusion as to
the "relevant market" in which it takes place, leading to much reduced cost in its application compared to existing laws. Ninth, such a law has the advantage of expressing a clear boundary to acceptable market conduct by all firms.

We have summarized these conclusions in the form of a model law which, we advocate, proscribes, more precisely than existing laws, the socially undesirable market conduct associated with dominance. We contend that its adoption would release today's Prometheans from the unnecessary torment of an imprecise, and therefore unduly binding, law.
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Appendices

Appendix 1

Countries Which have an Existing Dominance Law

Australia, Austria, Belgium, Canada, Denmark, the European Community, Finland, France, Germany, Greece, Japan, Luxembourg, Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, United Kingdom and United States\(^1\).

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Appendix 2

Dominance Laws of Australia, Canada, European Community,
New Zealand and the United States

Australia - s.46 of the Trade Practices Act

(1) A corporation that has a substantial degree of power in a market shall not take advantage of that power for the purpose of -

(a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;

(b) preventing the entry of a person into that or any other market; or

(c) deterring or preventing a person from engaging in competitive conduct in that or any other market.

(2) If -

(a) a body corporate that is related to a corporation has, or 2 or more bodies corporate each of which is related to the one corporation together have, a substantial degree of power in a market; or

(b) a corporation and a body corporate that is, or a corporation and 2 or more bodies corporate each of which is, related to the corporation, together have a substantial degree of power in a market,

the corporation shall be taken for the purposes of this section to have a substantial degree of power in that market.

(3) In determining for the purposes of this section the degree of power that a body corporate or bodies corporate has or have in a market, the Court shall have regard to the extent to which the conduct of the body corporate or of any of those bodies corporate in that market is constrained by the conduct of -

(a) competitors, or potential competitors, of the body corporate or of any of those bodies corporate in that market; or
(b) persons to whom or from whom the body corporate or any of those bodies corporate supplies or acquires goods or services in that market.

(4) In this section -

(a) a reference to power is a reference to market power;

(b) a reference to a market is a reference to a market for goods or services; and

(c) a reference to power in relation to, or to conduct in, a market is a reference to power, or conduct, in that market either as a supplier or as an acquirer of goods or services in that market.

(5) Without extending by implication the meaning of sub-section (1), a corporation shall not be taken to contravene that sub-section by reason only that it acquires plant or equipment.

(6) This section does not prevent a corporation from engaging in conduct that does not constitute a contravention of any of the following sections, namely, sections 45, 45B, 47 and 50, by reason that an authorization is in force by reason of the operation of section 93.

(7) Without in any way limiting the purpose of a person may be established for the purposes of the Act, a corporation may be taken to have taken advantage of its power for a purpose referred to in sub-section (1) notwithstanding that after all the evidence has been considered the existence of that purpose is ascertainable only by inference from the conduct of the corporation or of any other person or from other relevant circumstances.

Canada - ss. 78 & 79 of the Competition Act

78. For the purposes of section 79, "anti-competitive act", without restricting the generality of the term, includes any of the following acts:

(a) squeezing, by a vertically integrated supplier, of the margin available to an unintegrated customer who competes with the supplier, for the purpose of impeding or preventing the customer’s entry into, or expansion in, a market;

(b) acquisition by a supplier of a customer who would otherwise be
available to a competitor of the supplier, or acquisition by a customer of a supplier who would otherwise be available to a competitor of the customer, for the purpose of impeding or preventing the competitor's entry into, or eliminating the competitor from, a market;

(c) freight equalization on the plant of a competitor for the purpose of impeding or preventing the competitor's entry into, or eliminating the competitor from, a market;

(d) use of fighting brands introduced selectively on a temporary basis to discipline or eliminate a competitor;

(e) pre-emption of scarce resources or resources required by a competitor for the operation of a business, with the object of withholding the facilities or resources from a market;

(f) buying up of products to prevent the erosion of existing price levels;

(g) adoption of product specifications that are incompatible with products produced by any other person and are designed to prevent his entry into, or to eliminate him from, a market;

(h) requiring or inducing a supplier to sell only or primarily to certain customers, or to refrain from selling to a competitor, with the object of preventing a competitor's entry into, or expansion in, a market; and

(i) selling articles at a price lower than the acquisition cost for the purpose of disciplining or eliminating a competitor.

79(1) Where, on application by the Director, the Tribunal finds that

(a) one or more persons substantially or completely control, throughout Canada or any area thereof, a class or species of business,

(b) That person or those persons have engaged in or are engaging in a practice of anti-competitive acts, and

(c) the practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market,

the Tribunal may make an order prohibiting all or any of those persons from engaging in that practice.
(2) Where, on application under subsection (1), the Tribunal finds that a practice of anti-competitive acts has had or is having the effect of preventing or lessening competition substantially in a market and that an order under subsection (1) is not likely to restore competition in that market, the Tribunal may, in addition to or in lieu of making an order under subsection (1), make an order directing any or all the persons against whom an order is sought to take such actions, including the divestiture of assets or shares, as are reasonable and are necessary to overcome the effects of the practice in that market.

**European Community - art.86 of the E.E.C. Treaty**

Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States. Such abuse may, in particular, consist in:

(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;

(b) limiting production, markets or technical development to the prejudice of consumers;

(c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

**New Zealand - s.36 of the Commerce Act**

(1) No person who has a dominant position in a market shall use that position for the purpose of -

(a) restricting the entry of any person into that or any other market; or

(b) preventing or deterring any person from engaging in competitive conduct in that or any other market; or
(c) eliminating any person from that or any other market.

(2) For the purposes of this section, a person does not use a dominant position in a market for any of the purposes specified in paragraphs (a) to (c) of subsection (1) of this section be reason only that the person seeks to enforce any statutory intellectual property right within the meaning of section 45(2) of this Act in New Zealand.

(3) Nothing in this section applies to any practice or conduct to which this Part of this Act applies which has been authorised pursuant to Part V of this Act.

United States - s.2 of the Sherman Act

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony; and, on conviction thereof, shall be punished by fine not exceeding one million dollars if a corporation, or, if any other person, one hundred thousand dollars or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.
Appendix 3

Proposed Model Law for the Regulation of Socially Undesirable Market Conduct Associated with Dominance

(a) A person shall not engage in exclusionary conduct.

(b) In this section, exclusionary conduct means market conduct, other than competitive conduct, which prevents, or is likely to prevent, directly or indirectly, any person from engaging in market conduct necessary in order to

(i) supply a product or products demanded by a customer or customers; or

(ii) influence the demand of a customer or customers for a product or products.

(c) In this section, competitive conduct means conduct which has the substantial purpose of enabling the person engaged in the conduct to

(i) supply a product or products demanded by a customer or customers; or

(ii) influence the demand of a customer or customers for a product or products.

(d) In this section, prevent includes substantially restrict or hinder.

(e) It shall be a defence to any proceedings under this section if the person is shown to have acted for a purpose other than a commercial purpose.

(f) For the purpose of this section, a person shall be deemed to have acted for a commercial purpose if the person has acted for the purpose of increasing the profitability, or reducing the losses, of the business.

(g) Without in any way limiting the manner in which the purpose of a person may be established, a person may be taken to have acted for a purpose referred to in this section notwithstanding that after all the evidence has been considered the existence of that purpose is ascertainable only by inference from the conduct of that person or any other person or from other relevant circumstances.
(h) For the purposes of this section, a person shall be deemed to act or have acted for a particular purpose if

(i) the person acts or acted for purposes that included or include that purpose; and

(ii) that purpose is, or was, a substantial purpose.