COMMENTS ON

HONG KONG COMMERCE AND ECONOMIC DEVELOPMENT BUREAU

DETAILED PROPOSALS FOR A COMPETITION LAW (May 2008)

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For several years, Hong Kong has been considering the adoption of a competition law, and its current thinking is embodied in the draft published in May 2008.[1] The proposals have been subjected to extensive discussion over a considerable period of time, and promulgation of a final document may be close.

The proposals are written at a relatively high level of generality. As the document notes, the government has been working with "international experts" in competition law, and it has studied "best practice in other jurisdictions." In essence, the work appears to adopt the conventional wisdom on competition policy that prevails in the United States (US) and the European Union (EU), leaving the specific application of this wisdom to the antitrust authorities in the future.

This approach is problematical, and Hong Kong would be wise to undertake a more basic reconsideration of the conceptual bases for competition policy, because in fact the "best practice" in the US and EU has serious theoretical and practical flaws.

A number of academicians have pointed to these flaws, as have a few apostate practitioners. Edwin S. Rockefeller recently wrote:

> The antitrust laws provide a vehicle for the antitrust community to carry on a useless, mischievous activity portrayed as law enforcement. . . . Although today's antitrust community is alive and well, antitrust is atrophying. It is becoming a relic, an anachronism, the irrelevant debris of past political demagoguery. Education in the antitrust facts of life could accelerate the process.[2]

Indeed, the fact that practices or doctrines are accepted in the EU and the US might well be regarded as a good reason to subject them to strict scrutiny. As Dr. Kelly Busche of the Hong Kong Center for Economic Research noted a decade ago, "The Hong Kong Consumer Council . . . proposed competition laws that are patterned after policies and laws in . . . 'advanced' countries. That should not necessarily give us confidence."[3]

Here are some areas that should be probed in more depth before Hong Kong adopts any policy patterned after the "advanced" countries.

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[1] Hong Kong, Commerce and Economic Development Bureau, *Detailed Proposals for a Competition Law – A Public Consultation Paper* (May 2008) http://www.cedb.gov.hk/citb/ehtml/Consultation_Paper_Eng.pdf.

[2] Edwin S. Rockefeller, *The Antitrust Religion*, Cato Institute, Washington DC (2007), pp. 99-103 http://www.catostore.org/index.asp?fa=ProductDetails&method=&pid=1441371. The antitrust industry tends to dismiss its academic critiques as kooks, but Mr. Rockefeller's opinion cannot be easily discounted. He is a former Chairman of the American Bar Association's Section of Antitrust Law, and Chairman of the Bureau of National Affairs' *Antitrust & Trade Regulation Report*.

[3] Dr. Kelly Busche, "A Consumer's Report on an Immodest Proposal," Hong Kong Center for Economic Research, *HKCER Letters*, Vol. 31 (March 1995) http://www.hku.hk/hkcer/articles/v31/rbusche.htm.

The Meaning of "Competition" and "Anti-Competitive"

Since the bedrock rationale of antitrust is protection of "competition" and "the competitive system" against "anti-competitive" conduct, reasonable people might expect these concepts to be well-defined. They would be wrong.[4]

Competition can refer to the structure of an industry or market. It can mean something like the economists' model of perfect competition, a system in which all economic entities are so atomized that no one has power over anything. Or, since this world cannot exist outside of a textbook, competition can mean nothing more than non-monopoly -- that there is more than one firm, or perhaps that there are several firms. Or perhaps, somewhat more artfully, that there are "enough" firms to make it difficult for them to act in parallel. Or perhaps only that there are other firms that might enter, or that the firms already in an industry think might enter even if they wouldn't.

On the other hand, "competition" is also used to describe conduct, not structure. It may refer to a system in which rivals try to outdo each other. In this context, "anti-competitive" might mean any action that reduces rivalry between any two firms. On the other hand, sometimes it might not mean this at all. Perhaps reducing rivalry between the two firms would help the combination out-compete other firms, in which case an action that seems anti-competitive is actually pro-competitive. Unless, of course, the combination might overwhelm some third firm, which could reconvert the anti-competitive action that was actually pro-competitive back into anti-competitive. Or it might not, depending on the possible impacts on firms four and five.

All of these potential impacts, of course, are assessed via the vagaries of prediction through economic analysis, a black art in which everything is relevant, nothing determinative, and the only certainty is that much time and money must be spent.

Proponents of the proposed competition policy should be asked for specific definitions of the fundamental terms involved. At present, Hong Kong apparently plans to import on a wholesale basis the confusion that characterizes the EU and the US. For example, see the introductory language to Section IV, on *Prohibitions against anti-competitive conduct*:

> We propose that the law prohibit anti-competitive conduct in two broad areas: participation in agreements and concerted practices that have the purpose or effect of substantially lessening competition; and abusing substantial market power with the purpose or effect of substantially lessening competition.[5]

This description does not actually define anything, and the subsequent assurance that the Commission will issue guidelines is not reassuring when there is no way for the Commission to determine what the guidelines should contain.

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[4] See James V. DeLong, *Antitrust Law for Dummies*, *TCS Daily* (April 17, 2000) http://tcsdaily.com/article.aspx?id=041700H.

[5] *Detailed Proposasl*, p.8.

Market Definitions

The confusion over fundamental concepts manifests itself in many ways. An obvious one is in the area of market definition. Defining a "relevant market" -- determining what products might serve as alternatives to the products under examination -- is a key step in antitrust analysis. The narrower the definition of the market, the more likely that some affront to competition can be discerned.

Some of the U.S. government's market definitions are:

> "high-priced, nonethnic, frozen entrees."
> "bagged dry-mix concrete in the Washington-Baltimore area";
> "beer production and distribution within the State of Kentucky";
> "direct contract front-loaded trash removal in Dallas";
> "home and office staplers";
> "traditional department stores in Milwaukee"; and
> "noncarbonated, ready to serve, naturally or artificially flavored fruit drinks,fruit punches, or fruit ades which contain 50 percent or less fruit juice and are customarily sold under refrigeration to the consumer."
> "gourmet spice market." [6]

In attacking a proposed merger between Office Depot and Staples, the US Federal Trade Commission (FTC) defined the relevant market as "office supplies sold by superstores," even though the two chains together sold only about 5 percent of all office supplies, Wal-Mart alone sold more than this, and bulk mail-order firms sold another huge chunk.[7]

In assessing the market for butter in one medium-size city in the US, the Department of Justice found four distinct markets based on the combinations of branded and un-branded, stick and whipped. [8]

In a 2007 case, the government contended that "premium natural and organic supermarkets" constitute a separate market, unaffected by conventional supermarkets or their gourmet sections, specialized gourmet shops, or any of the other multitudes of competitors for the green or organic dollar.[9]

Given market definitions of this ilk, antitrust threats can be found everywhere Is this the "best practice in other jurisdictions" that should be emulated by Hong Kong? Proponents of competition policy should be asked for more detail on their views of market definition.

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[6] William F. Shughart II, *The Government's War on Mergers: The Fatal Conceit of Antitrust Policy*, Cato Institute Policy Analysis (Oct. 22 1998) http://www.cato.org/pub_display.php?pub_id=1182.
[7] DeLong, Note 4.
[8] U.S. v. Dairy Farmers of America, Civil Action No. 00-1663, ED PA, DOJ Competitive Impact Statement (June 2000) http://www.usdoj.gov/atr/cases/f6300/6376.htm.
[9] Thomas Lambert, "Four Lessons from the Whole Foods Case," *Regulation* (Spring 2008) http://www.cato.org/pubs/regulation/regv31n1/v31n1-4.pdf.

Static vs. Dynamic Analysis and the Marginal Cost Issue

The intellectual model that dominates antitrust is the concept of static equilibrium, and the assumption that a "competitive price" is the price that equals marginal cost and ensures short term static efficiency.

This assumption leads to profound error, as noted by distinguished economist William Baumol:

> Economists have generally been careful to point out that perfect competition is an artificial concept, albeit a useful and powerful analytic device. . . But the optimality properties long associated with this market form … have tempted some who are not as careful as they should **be to invite regulators and antitrust authorities to use perfect competition theory for guidance in their rulings**, as a way to promote the public interest. For example, only this year I heard a conference presentation dealing with the economic and legal principles of copyright suggest that the innovating Schumpeterian entrepreneurs are automatically to be deemed proper subjects for antitrust attentions because in the period before imitators enter the market, they can charge prices that exceed the marginal-cost levels of perfect competition. Never mind that this is a prescription for undermining intertemporal efficiency. Never mind that marginal-cost pricing would generally preclude recoupment of the research and development (R&D) costs of the innovations at issue, costs that will have to be incurred many times again if innovation is to continue. And never mind that a world of perfect competition requires constant returns to scale and firms so small that they would never attract the attention of regulatory or antitrust personnel.[10]

The misapprehension has particularly deleterious effects when competition policy is intertwined with issues of intellectual property. Policy Analyst Solveig Singleton focused on this issue:

> [T]he difference [is] between static and dynamic efficiency. The efficiency measure of the [marginal] cost models described above is static, in the sense that it does not allow for change over time. The model offers a definition of "efficient" or "inefficient" to which a snapshot of reality at a given instant conforms or does not conform. If prices fail to be set at marginal cost, one is done; one has found static inefficiency.
> . . . .
> Since the real economy must deal with incentives to invest over time, dynamic efficiency is more relevant than static efficiency. A firm with market power earns high profits; this creates an opportunity for a new entrant into the market to come in and undercut the first price. No large firm has more than a transitory advantage. In Schumpeter's well-known description of creative destruction, he notes that during the period when a large firm does enjoy an

[10] William Baumol, *Regulation Misled by Misread Theory: Perfect Competition and Competition-Imposed Price Discrimination,* American Enterprise Institute (March 16, 2006), p.1 http://www.aei.org/books/bookID.850/book_detail.asp.

> advantage, it is able to pour extensive resources into research and innovation. Empirical business studies such as the *The Rule of Three* recently confirm the vulnerability of large firms to competition, even as markets tend to mature around a few dominant players and some small niche firms. There is no perfect competition, but neither is there stagnation of the sort that harms consumers. [Footnotes omitted][11]

In antitrust writing, obeisance is often paid to concepts of dynamic analysis and Schumpeterian competition. US antitrust chiefs can be quite eloquent on the issue.[12] But the level of integration of dynamic thinking into the system as a whole tends to be shallow, and there is a strong bureaucratic tendency, familiar to anyone who as ever served in government, to justify whatever one was doing anyway in terms of the buzzword *de jour*.

Also, as Baumol says, backsliding is easy, particularly since dynamic processes do not easily lend themselves to modeling and prediction, which leaves regulators and practitioners without much to say, and thus without much saleable expertise. The institutional incentives to retain the old ways are formidable.

This criticism is not abstract, because the tendency of the system to assume that static equilibrium and marginal cost pricing provide the property normative standard is demonstrated repeatedly in actual decisions. To take some recent examples:

- Yale professor George Priest comments:

  > This paper discusses how the special economic features of networks and, in particular, practices that networks adopt to enhance network benefits, requires a reconceptualization of modern antitrust analysis. The proposition is demonstrated by the example of several recent antitrust prosecutions of network practices where the economics of networks were largely ignored.[13]

  Ignoring economics of networks is a rather serious flaw in an antitrust regime that purports to improve the efficiency of a world in which the importance of global networks is high and rising.

- The US FTC is conducting a long campaign to try to prevent restructuring of a hospital industry that is widely regarded as outmoded and inefficient. Why the antitrust authorities, relying on the limited standards of static antitrust analysis, should determine the correct structure of a hospital industry that needs dynamism and

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[11] Solveig Singleton, *Is Cheaper Always Better? Misusing the Concept of Marginal Cost in Policy Discussions*, Convergence Law Institute (Discussion Draft) (July 24, 2008). http://www.convergencelaw.com/Jargon_Anonymous.(00186370).pdf.

[12] See, *e.g.*, Thomas Barnett, *Competition Enforcement in an Innovative Economy* (June 20, 2008) http://www.usdoj.gov/atr/public/speeches/234246.htm.

[13] George L. Priest, *Rethinking Antitrust Law in an Age of Network Industries* (2007) (Abstract) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1031166.

change, within the context of a massive and complicated health care system, does not seem to be regarded as relevant by the Commission.

- The merger between XM Satellite Radio and Sirius finally cleared the US Federal Communications Commission and the Department of Justice last week, after over a year of duplicative review, analysis, bargaining, and millions of dollars in fees for legal and economic consulting. During this suspended animation, the economic problems of the companies have deepened, to the point where survival of the merged entity is in doubt.

  All this delay and expense was a waste. There was nothing known at the end of the process that was not known at its beginning. The whole exercise was necessitated by difficulties in reconciling the obviously desirability of a merger with the artificial constraints and market definitions imposed by the antitrust system, and in particular by the debate over market definitions. The pressure to delay action came from competitors, not consumers. In addition, to gain approval, the satellite companies were forced to make substantial economic concessions demanded by supposed "public interest" groups that will increase their financial distress.

  The author, as a devoted listener to satellite radio, regards it as the best entertainment deal on the market today, and takes exception to the manipulation of the antitrust system in a way that actually harms me and the whole listener community. Our interest is in having a single company with sufficient market power to raise the price to a level where it can operate, not in getting low prices from two companies which then go broke, leaving listeners with nothing. An antitrust system that cannot recognize this elementary fact is malfunctioning.

The Antitrust Industry

While one might think that such flaws would be widely publicized, and acted upon, this does not happen. The reasons appear to be related to elementary public choice considerations. Both antitrust enforcers and defenders are members of a very lucrative industry, as noted by Robert Reich in 1980 in *The Antitrust Industry*.[14] Its members change places via the revolving door, and multi-millions of dollars are reaped annually from arguments over the minutiae of specific cases. Serious reconsideration of basic issues is not in the collective interests of the members of this industry. Nor is expeditious treatment of matters such as the XM/Sirius merger.

A decade ago, I wrote:

> In the 1960s, scholars with a public choice perspective began analyzing whether past antitrust actions had actually benefited consumers. It is not an easy question to research, but a variety of ingenious studies have looked at stock prices, scholarly opinions, competitors' reactions, and other indicators. The results are strikingly consistent:

[14] Robert Reich, "The Antitrust Industry," 68 *Georgetown Law* Journal 1052 (1980).

> Antitrust actions do not help the public, though they may help the special interests that trigger them (while providing well-paid employment for antitrust professionals). CEI's 1997 Antitrust Reader and the 1995 book The Causes and Consequences of Antitrust: A Public Choice Perspective (University of Chicago Press), edited by Shughart and Emory University economist Fred McChesney, are good introductions to this literature.
>
> This research, combined with the dearth of empirical work on the other side, was an important factor in the reforms of the 1980s. Proponents of interventionist antitrust had an embarrassing lack of good examples. As McChesney and Shughart point out, when you have a century of experience with a program and virtually every landmark case looks to have been a mistake, perhaps it is time to stop saying, "well, we'll get it right next time," and start rethinking the basic premises. [15]

These conclusions remain valid. And, one should add a note on the irony that the economics profession, which is exceedingly fond of excoriating various businesses as "rent seekers" – profiteers from government regulations that inhibit efficiency – has become a leading example of the rent-seeking phenomenon.

* * * *

The conclusion is simple. Whether Hong Kong needs a competition policy, and what principles any such that policy should embody, is an interesting question. But in answering it, Hong Kong would be wise to take account of Dr. Busche's advice. If an argument for a proposed policy is that it is modeled on the policies adopted in the "advanced" countries, Hong Kong should probably reject it out of hand, and develop its own, based on more realistic consideration of the Schumpeterian nature of the modern economy. It should also look askance at proposals advanced by unified antitrust industry, which may be more in the interests of that industry than in the interest of either consumers or businesses.

Even price fixing, which is regarded by conventional wisdom as clearly damaging, presents issues in need of serious analysis. As Robert Bork noted in 1978, the *per se* ban on price fixing forestalls "partial integrations" among firms, integrations that might be productive.[16] Because such relationships are prevented, the only available alternative is full integration by merger, so the ban on price fixing increases the pressure for a concentrated industrial structure.

In addition, the absurdity of dis-allowing all partial integrations that contain a price term becomes obvious in practice from time to time. The need to permit them leads to such circular convolutions as the *Broadcast Music* case, in which the US Supreme Court noted that fixing prices is not the same thing as price fixing, and that the term "price fixing" is simply a shorthand for referring to practices that have been determined to be illegal.[17]

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[15] See also James V. DeLong, "The New Trustbusters," *Reason* (March 1999) http://www.reason.com/news/show/30941.html.
[16] Robert Bork, *The Antitrust Paradox* (1978).
[17] Broadcast Music, Inc. v. CBS, 441 U.S. 1 (1979).

It may be that the major objection to price fixing is the element of deception. A buyer thinks that rivalry is keeping prices down, but in fact this policing mechanism is not operating. If the buyer knew this, it would seek more information, or ask additional firms to bid on a contract, but it is lulled by the secrecy.

Thus Hong Kong might want to ban price-fixing-to-monopoly and secret price fixing, but allow price fixing that leads to partial integrations. It is certainly worth considering.

This discussion of price fixing is meant only to provide an example of how completely existing doctrines need to be re-examined. No one disagrees with the objectives that competition law is supposed to promote, the maintenance of a flexible, innovative, efficient economic structure, but there is no reason to believe that current competition doctrine is serving these purposes. Quite the reverse; there is considerable reason to think that current doctrine is an increasingly serious drag on economic performance, and particularly on dynamic change.

Hong Kong has an opportunity to reconsider these issues, starting with a clean sheet of paper. More rational policy would, among other benefits, give Hong Kong industry a competitive advantage over industries that must operate under the sclerotic antitrust regimes of the "advanced" nations.

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