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Submission to competition policy review

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TAI

Submission

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Contents

Introduction 2
Problems in the application of the theory of competition 3
Limitations on competition 3
When competition is perverse 5
High rates of return on capital suggest a lack of competition 7
Retail trade 9
Non-price competition 11
Median customer issue 13
Waste 14
The problems of monopsony and oligopsony 16
Squeezing farmers 17
Intellectual property (IP) 19
Education, health and disability care and support 21
Policy implications 23
Conclusions 25
References 27

Introduction

The government announced the terms of reference for the competition policy review on 27 March 2014. The issues paper[1] was released on 14 April and invited submissions.

The issues paper takes it for granted that competition is a good thing and that competition will ensure a market is well-behaved and delivers benefits to consumers. For example it says:

> *The benefits of competitive markets include lower resource costs and overall prices, better services and more choice for consumers and businesses, stronger discipline on businesses to keep costs down, faster innovation and deployment of new technology, and better information allowing more informed consumer choices. Competitive markets are dynamic and innovative, which can benefit Australians both now and into the future.*[2]

That is the theory. However, in practice there are often winners among the competitors and instead of competing with each other the remaining participants settle down and form a concentrated market structure in which the firms can act as monopolists/oligopolists.[3] When that happens there is an effective conspiracy against the public to milk as much profit as possible out of the market. Adam Smith warned that businesspeople were very prone to band together and act collectively to advance their interests when he said:

> *People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.*[4]

The review recognises that ‘Australia’s key markets are relatively concentrated’ and it does mention that non-price competition is an important feature of many markets. Non-price competition can mean a host of business strategies from advertising to fraud and other criminal activities. Then there are grey areas between price and non-price competition.

Woollies and Coles have recently won a case against an Australian Competition and Consumer Commission (ACCC) ruling on petrol price discounting. They both know that price discrimination in favour of supermarket customers is anti-competitive behaviour and certainly against the spirit of the law yet engage in that behaviour just to the point they think they are safe from being found guilty. That sort of behaviour demonstrates why the law is essential. Often players go to the limit of the law so the law then provides the boundary around which the market players concentrate.

Over and over again we keep finding empirical evidence and theoretical anomalies that point to the fact that in many areas the market is broken. When the market does not work well it is likely that various providers will be making excessive profits.

In the case of the mining industry we are very clear that competition is not going to drive out excess profit. The reason is that mining companies receive ‘economic rents’. Given world commodity prices Australia’s superior reserves mean that Australian miners will earn more

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[1] Australian Government Competition Policy Review (2014) *Issues Paper*.
[2] Australian Government Competition Policy Review (2014) *Issues Paper, p. 1.*
[3] We do not intend to be strict in this submission about the terms ‘monopoly’, ‘oligopoly’ and ‘duopoly’ and will often refer just to ‘monopoly’. The boundaries between these terms is often blurred and all non-competitive behaviour is a sort of monopoly behaviour in that it means the player in question has some degree of market power. The latter is the hallmark of a monopoly.
[4] Smith A (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations*, London: Methuen &Co. Ltd, p. 82.

than the going rate of return and those superior profits will not be bid away by competition from other suppliers so long as Australian mines are much superior to those in the rest of the world. Other industries also earn economic rents. For example, the big banks are so profitable because they can earn rents through their operation of the payments system in Australia as well as operating with economies of scale. It seems that rents are in fact a common part of the Australian economic landscape.

The rate of return on fixed capital in Australia is 14.3 per cent when calculated from the national accounts.[5] That of course is much greater than the going rate of return which is proxied by the present bond rate or its average value over recent decades. A high rate of return indicates there are many rents being appropriated by Australian companies. The Australia Institute has published fairly extensively on the problems posed by economic power and industry concentration in modern Australia. Hence The Australia Institute is in a good position to make a submission to this inquiry.

Problems in the application of the theory of competition

Limitations on competition

There is a common misunderstanding about competition between firms for the custom of Australian purchasers. It is seen as akin to a game of cricket where teams meet and try to get each other 'out' by bowling at the batsman in a clearly defined way (straight arm, without overstepping the bowler's crease, etc). In the same way sellers are assumed to play fair and compete for our custom by trying to tempt us with their lowest possible price. The competition is assumed to focus on price.

The outcome of competition is often that one or a small group of producers "wins". They are able to take over their competitors or drive them out of business. That might be a result of better cost efficiencies but it may instead reflect various non-price attributes. If it is indeed the result of more efficient production then potentially we are all better off as a result of company X winning the competition.[6]

In practice competition is more like guerrilla warfare—virtually anything goes in trying to increase sales including illegal practices when there is little likelihood of being caught. Companies may well use prices to attract consumers but that is only one of the possible tactics and we outline some of them below. The important thing is that in some markets there is less scope to misrepresent the product or build brand recognition or adopt some of the other practices that we outline below. For example, farmers have a hard time competing on anything other than price when they are producing products identical to those of other farmers and (often) they face sophisticated wholesale buyers.

In theory a large number of competitive suppliers will have the effect of producing for a market which is transparent and in which consumers are able to easily pick the best option and purchase a known product at the cheapest price.

Oligopolies occur when there are 'entry barriers' that deter new firms from entering a market to provide competition for existing firms in that market. There are many factors that can impose entry barriers to new firms but they tend to fall into three categories:

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[5] ABS (2013) *Australian system of national accounts, 2012-13*, Cat no 5204.0, 1 November. The basis for this calculation is to compare the gross operating surplus (excluding dwellings), with the capital stock excluding dwellings.

[6] But not if it leads to abuse of power in other ways – robber baron behaviours.

- 'Economies of scale' tend to be important in a small country like Australia. 'Economies of scale' refer to the tendency in many industries for production costs to fall as output increases. With economies of scale big firms that dominate the market are lower cost providers compared with potential new entrant to the market. Unless a new entrant can be sure of capturing a large share of the market it is unlikely to produce at a comparable cost and so will lose out in the competition with the incumbents.
- Absolute cost advantage on the part of incumbent firms is also a potential barrier to entry. Where the incumbent firm/s have some inherent cost advantage such as their location that advantage will persist despite competition. For example: Microsoft Office will always have an advantage because virtually all office workers can receive and send documents knowing they can be read by any other party.
- Product differentiation is also an important barrier to entry. Hence a new provider of music will be forced to put new and unknown artists into the market in competition with established artists from the incumbent providers. In addition, fashion houses are able to maintain a profitable existence by managing their brand.

  Recently a report was published showing the importance of brand identification and put estimates on the value of the brand to its owner/s. Apple is now the world's highest valued brand at $153 billion.[7] That amount is essentially the capitalised value of its additional profits expected as a result of the market power it obtains from its brand.

Incidentally economies of scale that enable uncompetitive industries also imply that the efficient scale of production is more likely to be met in firms that enjoy significant market power. On top of their existing advantages incumbent firms know that they can earn excess profits without attracting new entrants since any new entrant may have to survive aggressive price cutting behaviour. New entrants cannot expect that incumbent firms will passively accept their arrival in the market.

It has long been recognised that oligopolistic competition eschews price competition and instead competition is based on the attributes of the product and attempts to whip up enthusiasm for new features. Nobel prize winning economist Michael Spence refers to 'non-price competition' as 'activities by firms or corporations that shift the demands for products, their own and those of their rivals'.[8] Generally the implication of oligopolistic competition is that resources are wasted in unnecessary competition. As an example Spence referred to the petroleum industry and its 'excess of non-price competition in retail outlets, advertising and promotions of a variety of kinds'.[9] Hence competition to make buying petrol more convenient meant an oversupply of petrol stations that were often situated across the road or next door to each other. In the airline industry scheduling rivalry was observed to erode airline profits.[10]

In some oligopolistic markets excess profit may be competed away in a manner analogous to the way firms in perfect competition act so as the bring profits back to some normal rate. But the big difference is that returns are reduced to normal because costs are inflated by

[7] WPP (2011) 'Apple becomes the world's most valuable brand, says WPP's BrandZ' *Press Release*, 9 May at http://www.wpp.com/wpp/press/press/default.htm?guid={c7fa34c1-d97b-4833-a356-bee9ac16e161}

[8] Spence M (1977) 'Nonprice competition', *American Economic Review, Papers and Proceedings*, May, pp 255-9.

[9] Spence M (1977) 'Nonprice competition', *American Economic Review, Papers and Proceedings*, May, p 255.

[10] Schmalensee R (1977) 'Comparative static properties of the regulated airline oligopolies', The Bell Journal of Economics, Vol 8, Autumn, pp 565-76.

wasteful competition whereas genuine competition would see monopoly profits competed away to the benefit of the consumer.

The non-price mechanisms that have been examined here so far are at least open and transparent. We can all see the ‘cost padding’ that goes into the oversupply of retail outlets, proliferation of models, and extraneous features on products from mobile devices through to perfume bottles,

It is often tempting to accuse big business of immoral or unethical conduct. Such conduct may well take place from time to time but we would argue that the whole economic system relies on the producers self-interest as the references to Adam Smith made clear. Self-interest or greed was never thought of as anything than a fairly base motive and can include unethical conduct predatory behaviour and the rest. However, the point of Adam Smith and subsequent writers was competition (and the rule of law) channels self-interest into socially desirable directions. It is the absence of competition (or effective law enforcement) in one form or another that tends to generate the evils associated with big business. For example we might complain about the massive profits earned by the banks but the local delicatessen is no less averse to charging exorbitant prices if they think they can get away with it. In a market system companies are supposed to vigorously pursue their shareholders’ interests and it is supposed to be competition that holds them in check—not their own self-restraint.

When competition is perverse

In many markets more competition is not necessarily a good thing. There is for example the ratings agency problem which involved new players that increased competition between the ratings agencies but, as the Organisation for Economic Cooperation and Development (OECD) reported, the increased competition resulted in ‘ratings grade inflation’ as the agencies competed for new custom or to retain old customers. The OECD said ‘the agencies made discretionary upward adjustments in ratings in efforts to retain or capture business, a direct consequence of the issuer-pays business model and increased concentration among investment banks. Issuers [ie a smallish number of firms wanting their products to be rated] could credibly threaten to take their business elsewhere’.[11]

A similar example involved increased competition in New York’s vehicle testing centres. In this case the service providers are also acting as the regulator of New York’s emission standards. In New York vehicles have to be periodically tested for pollution control and owners can choose which privately operated testing centre to attend. The result was quick testing and easy passing which resulted in testing centres improperly passing vehicles so as to achieve customer loyalty. A study found that as the number of competitors increased so did the pass rates.[12] New businesses were more likely to be lenient and pass polluting vehicles. Honest businesses risked losing business to dishonest competitors. A study fund that it was new entrants, and increased competition which contributed to this outcome by obliging all suppliers to adopt unethical practices to remain viable.[13] The study concluded that

> *Policy makers must consider whether competition is the ideal market structure when corruption, fraud, or other unethical behaviors yield competitive advantages. If customers indeed demand illicit dimensions of quality, firms may feel compelled to cross ethical and legal boundaries simply to survive, often in response to the unethical behavior of just a few of their rivals. In markets with such potential,*

[11] OECD (2011) *Bank Competition and Financial Stability*, OECD Publishing 27 October, p 210.
[12] Stucke ME (2013) ‘Is competition always good?’, *Journal of Antitrust Enforcement*, pp. 1–36
[13] Stucke ME (2013), p. 34.

> *concentration with abnormally high prices and rents may be preferable, given the reduced prevalence of corruption*[14]

The problem of perverse competition demonstrates that competition policy should never be treated as a one-size-fits-all policy. Instead regulators have to be satisfied that competition is the appropriate response to the problem at hand.

In principle the issues paper is right to suggest that competition is supposed to minimise costs by driving returns to capital down to market rates of return. Any appearance in a particular industry of higher profits than 'normal'[15] is a signal for new players to enter the market and that is supposed to have the effect of reducing returns back to the normal rate. Equally anything in the industry that drives returns below normal is a signal to players that it is worth exiting the industry until profit rates return to normal. Any firm not producing as efficiently as possible is punished with low returns and will eventually exit the industry and leave it to those who are efficient.

The present submission makes the point that the competition arguments often do not apply in Australia. In a recent publication Treasury officials argued that the level of economic rents in Australia were $64.4 billion in 2011-12[16] which was equal to 12.5 per cent of the gross operating surplus that year.[17] Incidentally 57 per cent of the rents or $36.8 billion was assumed to be in the finance sector.

Whether the Treasury estimate is correct or not we can agree that there are very high rents in Australia that are effectively a private levy on the Australian population equivalent to an indirect tax.[18] High economic rents are a sign that competition is inadequate to drive profits down to competitive returns.

Electricity

The history of electricity regulation and reforms is an interesting case study.[19] The cost of electricity increased by 170 per cent from 1995 to 2012, an increase four times higher than the rise in the consumer price index (CPI). This increase occurred despite the industry being subjected to privatisation and corporatisation for the past two decades, a process that promised to increase efficiency and lower prices. Yet it is likely privatisation has contributed to price increases. Output per worker has fallen markedly in electricity since the reform programs while it has increased in the rest of the economy.

Over the period June 1995 to the present, productivity across the economy as a whole increased by 33.6 per cent, while in the electricity sector it declined by 24.9 per cent. One explanation is the rapid increase in staff numbers in occupations that do not have a direct role in actually generating electricity. For example, the number of managers in the sector has

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[14] Bennett VM and others, 'Customer-Driven Misconduct: How Competition Corrupts Business Practices' (2013) *Management Science*, cited in Stucke ME (2013) 'Is competition always good?', *Journal of Antitrust Enforcement,* p. 35.

[15] The concept of the 'normal rate of return' is not well defined but the idea is that investors will make their own assessments of the going rate of return and be attracted to any opportunity that gives returns above the market rate of return or the returns available elsewhere.

[16] Rimmer X, Smith J and Wende S (2014) 'The incidence of company tax in Australia', *Economic Roundup (Treasury)*, Issue 1, pp 33-47.

[17] ABS (2013) *Australian system of national accounts, 2012-13*, Cat no 5204.0, 1 November.

[18] The mining tax is different but is effectively a private appropriation of the value of resources that are theoretically owned by all Australians.

[19] The following is based on Richardson D (2013) *Electricity and privatisation: What happened to those promises?* The Australia Institute, Technical Brief No. 22, April.

grown from 6,000 in 1997 to 19,000 in 2012, a rise of 217 per cent. This has seen the ratio of managers to workers change from one manager to every 13 workers in 1997 to one manager for every nine workers in 2012. An occupational category described as 'Business, Human Resource and Marketing Professionals' increased from 2,200 to 9,400. Likewise the sales staff increased from 1,000 to 5,000. In contrast to this, there was a much smaller increase in the group of people who are directly involved in producing electricity. Indeed, it looks like there was no decline in output per worker if we only count those that actually make electricity.

A similar thing happened to the capital costs associated with privatisation. Private buyers tend to pay more than the value of an electricity plant is worth because of the potential for monopoly profits. Having paid a premium these businesses are then obliged to seek high prices to achieve a competitive return. In this way further costs are passed onto consumers.

The architects of the privatisation, market creation and corporatisation programs clearly did not take into account the increases in functions that a player in a competitive market has to take on. The changes created the need for a sales team and marketing professionals. Along with sales teams and marketing professionals came deceptive and barely illegal practices. The sales and similar expenses seem imperative to a market player but are socially wasteful—especially for a commodity like electricity that sells itself.

High rates of return on capital suggest a lack of competition

We can test whether an industry is competitive by examining the returns in that industry. The figures to test the hypothesis that are assembled in Table 1 which uses national accounting figures to estimate the rates of returns in different industries using the gross operating surplus and mixed income in various industries and expressing that as a rate of return on the estimated net capital stock in the same industries. The advantage of using gross operating surplus and mixed income instead of profit itself is that the gross operating surplus is not affected by the financial leverage in the various industries.[20] By contrast actual profit depends on how the company is financed and therefore how much of the operating surplus is shared with the financiers. Unfortunately the downside is that the inclusion of gross mixed income contaminates the measure by including the implied labour income of owners and family in the non-corporate sector.

[20] Ordinary profit is net of any interest costs so that actual profitability depends on the degree of borrowing. However, the gross operating surplus does not deduct interest costs and can be thought of as showing all the non-labour income associated with an enterprise.

Table 1: Estimated rates of return on capital by industry.

	Gross Operating Surplus as return on capital (%)
Construction	107.0
Financial and insurance services	60.9
Professional, scientific and technical services	53.6
Other services	49.7
Retail trade	32.6
Administrative and support services	25.5
Wholesale trade	25.4
Agriculture	20.0
Information media and telecommunications	19.4
Manufacturing	19.0
Mining	17.5
Accommodation and food services	17.5
Health care and social assistance	13.1
Transport, postal and warehousing	8.7
Rental, hiring and real estate services	8.6
Arts and recreation services	8.3
Electricity, gas, water and waste services	7.2
Public administration and safety	6.4
Education and training	5.4
ALL INDUSTRIES	21.8

Source: ABS (2013) Australian system of national accounts, 2012-13, Cat no 5204.0, 1 November.

Table 1 clearly shows that while rents or rates of return are indeed high in financial and insurance services, as suggested by Treasury above, they are by no means unique in Australia. Of the 19 industries seven are uncompetitive if we use the agriculture benchmark as an example of a relatively competitive industry.[21] Using the alternative of rental, hiring and real estate services as the benchmark then there are 15 out of 19 industries that are uncompetitive. The remainder tend to be dominated by the public sector which tends to provide services at cost and the low profits reflect the relatively smaller participation by the private sector.

Construction with a rate of return of over 100 per cent seems extraordinarily high and the recent Productivity Commission draft report on infrastructure financing suggests that larger commercial construction in Australia is dominated by the duopoly; Lend Lease and Leighton Holdings. The PC estimates that these two companies account for about 60 per cent of infrastructure construction but the PC also cites a larger independent estimate of 75 per cent.[22]

Financial services are subject to a review by the financial services inquiry to which The Australia Institute has already made a submission.[23] The competition issues that arise from that are discussed below.

The next highest figure for profitability is professional, scientific and technical services followed by other services, retail trade, administrative and support services and then wholesale trade. Rather than dwell on aspects of each of these industries it is important here to take not of the fact that a lot of Australia’s strategic industries earn higher rates of return than would be sustainable in more competitive markets.

The high profitability of the various segments of the Australian economy reflects the concentration of firms in various market sectors. Indeed, we have argued elsewhere that the sales of just the top five non-financial listed companies in Australia amount to 16 per cent of GDP and the top 50 for over a third of GDP [24]. Privately owned big business generally accounts for 80 per cent of GDP using ABS definitions. International comparisons suggest that Australian banking is the most concentrated amongst comparable economies and in retailing Australia ranks second when measured in terms of retail turnover of the top two as a share of GDP. We have also shown that on top of the high concentration in some industries, the few firms that do exist tend to have common owners so that their real independence is questionable.

Retail trade

Retail trade is especially interesting and includes the duopolists Coles and Woollies as well as a host of small business traders in various segments of retailing. The ABS input output tables suggest there are very high mark-ups in parts of this industry. An earlier paper by The Australia Institute examined this issue gave some examples of the mark-ups by product type which are reproduced in Table 2.

[21] Unfortunately agriculture is likely to demonstrate apparent rates of return higher than normal because it includes a good deal of mixed income.
[22] Productivity Commission (2014) *Public infrastructure: Productivity Commission draft report, Vol 2*, March.
[23] Richardson D (2014) *Submission to the financial services review*, March.
[24] See Richardson D (2013) ‘Corporate power in Australia’ paper given to the Sydney Heterodox Economists Conference, December and the sources cited there. Note that sales to GDP ratios are intended here to show the size of companies relative to the economy as a whole. That should not be confused with the value added that might be produced by these companies which would give a better measure of their contribution to output in the Australian economy.

Table 2: Product average mark-up by type

Product type	Average mark-up
Clothes and shoes	142%
Other manufactured products	97%
Electrical and electronic goods[25]	85%
Furniture	76%
Books newspapers and magazines	52%
Fresh food[26]	47%
DVDs and music	40%
All goods retail mark-up	65%

Source: ABS (2010) Australian National Accounts: Input-Output Tables–Electronic Publication, Final release 2006–07, Cat no. 5209.0.55.001, 23 December.

These figures show that mark-ups in the retail sector seem to be excessive and suggest that 39 per cent of the value of consumer purchases support the retail sector.[27] The margin imposed by the retail sector acts as a large private tax burden on consumers. Our impression from inspection of the list is that the mark up is largest in segments that are characterised by more product differentiation on the part of producers. Hence sellers of clothes and shoes are able to charge a much higher mark-up than sellers of fresh food for example.

Non-price competition

It seems very clear that Australia's top companies are very profitable indeed. In this section we consider some of the strategies that companies employ to maintain or increase their profitability.

There is now a growing literature on the obfuscation we observe in uncompetitive markets. Shrouding and obfuscation are a form of competitive strategy that tends to be far too common. The mini bar phenomenon is an oft-cited example. In this case the add-on fees are actually 'shrouded' from view until the customer actually enters the hotel room. There are a number of similar cases – including the high add-on costs for computer printer cartridges and the relatively low quoted prices for base model motor vehicles. Shrouding is common where the consumer shows a greater sensitivity to up-front costs than delayed costs. On the Hewlett-Packard site, to get from a specific desk-jet printer site to the information about printing costs is further away from the printer home page (based on clicks) than any other information about the printer.[28]

[25] Professional, scientific, computer and electronic equipment manufacturing; electrical equipment manufacturing; and domestic appliance manufacturing
[26] Aquaculture; fishing, hunting and trapping; meat and meat product manufacturing; dairy product manufacturing; and fruit and vegetable product manufacturing

[27] When the average mark-up is 65 per cent the share of the sales price going to the retail sector is 39 per cent (= 0.65 divided by one plus 0.65 expressed as a percentage).
[28] Gabaix X and Laibson D (2006) 'Shrouded attributes, consumer myopia, and information suppression in competitive markets', *Quarterly Journal of Economics*, May.

One observer has noted that 'advances in search technology are accompanied by investments by firms in obfuscation'.[29] Indeed it appears that the increasing intensity of price competition as a result of internet search engines is responsible for the increased obfuscation efforts. A good example is the investment fund. If the fund explains to the consumer that its strategy is rarely effective in 'beating the index' but the fund involves management fees the newly educated consumer could buy an index fund with low fees that is at least as profitable (in the absence of fees). The educated consumer is now an unprofitable consumer so there is no incentive for the fund to educate the consumer—quite the opposite. Instead all fund managers are likely to brag that they can out-perform the index and so all will engage in deceptive strategies.

Gabaix and Laibson argue that shrouding the market in mystery is behaviour that is likely to persist and could not be addressed by more competition. One of the consequences of shrouding behaviour is advertising that takes the form of one-dollar-flights but conceals the hidden taxes, fees and charges until the consumer is set on purchasing a flight. Indeed this type of behaviour is so common in some markets that, for example, the European Commission has regulated to require airlines to quote prices inclusive of taxes, fees and charges.[30] In a similar vein automatic teller machines in Australia have to disclose fees and all Australian goods and services have to quote prices inclusive of the GST.

Another example of obfuscation is blatant false advertising, which is the main type of activity that the ACCC seems to be able to address. An example involved mobile phone company, Otpus, which was fined by the ACCC for falsely giving the impression that its 'max cap' plan meant the consumer would pay a maximum fixed amount and 'engaged in conduct that was likely to mislead consumers about the nature and characteristics of its services'.[31] That also gets to our earlier point about sailing close to the wind and trying to stay just within the law.

Because of the complexity of pricing in some markets and the consequent likelihood of consumer error there is evidence of high price suppliers attracting customers even though the latter were looking for low price providers. For example one study found that in the electricity market in the UK, consumers who looked for cheaper prices only achieved 26 to 39 per cent of the maximum gains available to them and over a quarter of consumers were actually worse off. The authors of the study concluded that 'consumers' poor choices seem more consistent with an explanation of pure decision error, perhaps as a consequence of the particularly complex market environment involving the use of complicated non-linear tariffs'.[32]

The retail financial products industry is another area of concern as we have touched on above. The internet made price search more efficient and so encouraged investment in obfuscation, so it seems more education on the part of retail financial investors has the effect of inducing greater efforts at obfuscation in the retail financial products industry.[33] The obfuscation is deliberately aimed at disorienting financial investors and so has the effect of reducing overall economic wellbeing. One of the strategies is to offer several classes of investment products to price discriminate among investors of various sophistication. As they put it 'discrimination through such purposeful distortions in transparency is an important

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[29] Ellison G and Ellison SF (2009) 'Search, obfuscation, and price elasticities on the internet', *Econometrica*, Vol 77, March, pp. 427-52, p. 427.
[30] Garrod L (2007). 'Price transparency and consumer naivety in a competitive market' *Centre for Competition Policy Working Paper*, No 07-10.
[31] ACCC (2011) 'Optus pays for "max cap" advertising' Press Release, 18 May at http://www.accc.gov.au/content/index.phtml/itemId/988219/fromItemId/142
[32] Wilson C and Waddams Price C, (2007) 'Do consumers switch to the best supplier?' CCP Working Paper 07-6, p. 27).
[33] Carlin BI and Manso G (2011). 'Obfuscation, learning, and the evolution of investor sophistication', *Review of Financial Studies*, vol 24, No 3, pp. 754-85.

source of value to providers' albeit at the expense of the financial investors.[34] The authors caution that efforts at raising the financial literacy of customers may be counterproductive if it only marginally improves financial literacy—it may just cause providers to increase their complexity to further obfuscate their offerings. Moreover the authors make the point that the disparity between the sophistication of the customers and complexity of the product offerings applies in other areas of the financial market which, especially in the US, have been involved in the build up to the global financial crisis. They have in mind here credit card financing, life annuities, mortgages, life insurance and education savings plans. As they stress 'participation without sophistication is frequently cited as a root cause of the recent financial crisis'.[35]

While education is important to overcoming obfuscation so too are default options: 'default options would in essence make more investors experts (by proxy) and may decrease obfuscation, especially when used on a grand scale or in markets in which people learn on their own'.[36] A default position was the solution chosen by the government in relation to superannuation default funds in Australia.

Median customer issue

Competition policy is confounded by the median customer issue. Hotelling years ago showed that a market characterised by a small number of sellers is likely to see them all catering for the median consumer rather than cater for the range of tastes that may exist in the market.[37] The latter will only happen when the number of players is quite large. That implies a role for government in for example establishing public broadcasters and, importantly, ensuring that their content is fundamentally different from the commercial operators who are likely to adopt common broadcasting approaches to cater for the median viewer.

The Australian department store sector appears to be another example of an industry that has over-catered for the median consumer. Hence we notice in practice that in smaller shopping complexes or shopping districts there will be mainly the large chains (booksellers, CD/DVD outlets, clothing etc) but in bigger shopping districts there are a much more diverse group of shops with much greater choice for consumers. It is more likely that Coles and Woolworthswill be challenged by specialist grocers, gourmet and suppliers in larger complexes. Likewise in small country towns the commercial radio stations are few and sound very similar. In larger cities there is a greater variety.

An implication of this sort of market failure is that the market will not produce the optimal solution in the absence of a large number of vendors. The perfectly competitive model would supply that solution under the assumption of a large number of suppliers. But in cases where there are only two alternatives they seek to be virtually the same which gives little real benefit to the consumer. Governments are often criticised for not letting the market work, for example, when they apply planning regulations that do not allow Coles to set up next to the incumbent Woolworths or vice versa. However, actions that seem to close off competition can often produce an efficient alternative. If Coles and Woolworths are really much the same then there is little point in co-location and by denying co-location the other is likely to set up elsewhere which then gives customers a variety of locations if not variety of content. In

[34] Carlin BI and Manso G (2011). 'Obfuscation, learning, and the evolution of investor sophistication', *Review of Financial Studies*, vol 24, No 3, p. 755)
[35] Carlin BI and Manso G (2011). 'Obfuscation, learning, and the evolution of investor sophistication', *Review of Financial Studies*, vol 24, No 3, p. 757.
[36] Carlin BI and Manso G (2011). 'Obfuscation, learning, and the evolution of investor sophistication', Review of Financial Studies, vol 24, No 3, p. 758.

[37] Hotelling H (1929) 'Stability in competition' *Economic Journal*, Vol 39, No. 1, pp 41-57.

addition, by preventing the dominance of the two there is more chance that the vendors that do set up next to the incumbent Coles or Woolworths will in fact offer a quite different and a genuinely alternative service.

In making these observations we suggesting that Coles and Woolworths are much alike but that more diversity is desirable. We would be open to the charge of elitism and that we should not be picking winners and that the market should decide. However, it seems we can make the proposition that the big incumbents do in fact target the median consumer and that licensing laws and other regulations can make a contribution to choice and diversity. Moreover, any presumption that the market should be allowed to 'decide' outcomes is difficult to sustain in the absence of genuine competition. This is merely another example of where market imperfections lead to suboptimal outcomes that imply government actions may produce a better result.

Waste

Uncompetitive markets are also associated in the literature with waste. A non-competitive company may well indulge in for example, gold plated executive bathrooms and plush boardrooms—unnecessary costs for sure but seem to be present among companies that do not experience any pressure to be a keen competitor. This practice was identified in 1966 and called "X-inefficiency" by Harvey Leibenstein. It is no exaggeration to suggest Leibenstein genuinely shocked the economics profession in terms of the magnitudes of waste involved. X-inefficiency is implied by the indulgences of companies in their senior executives for example. When the lack of competition allows super profits then some of that can be distributed as lavish boardrooms, corporate jets as well as excessive remuneration. It can also be reflected in inefficient producers who have little incentive to adopt best practice techniques.[38]

The issue paper mentions non-price competition just twice when it says:

> *Competitive markets are characterised by various forms of price and non-price competition between businesses seeking to provide what consumers want…Non-price competition involves businesses seeking to gain an advantage over rivals by differentiating the goods, services and terms they offer to make them more attractive to buyers—a key mechanism for small and medium-sized businesses to compete with large businesses.*[39]

One could read the issues paper and come away with the view that non-price competition is beneficial to consumers just like price competition. Advertising and marketing are features of non-price competition in uncompetitive markets whereby sellers try to convince us of other reasons (apart from price) why we should purchase their product.

Noam Chomsky has put it very well:

> *In commercial advertising as everybody knows, everybody who has ever looked at a television program, the advertising is not intended to provide information about the product, all right? I don't have to go on about that. It's obvious. The point of the advertising is to delude people with the imagery and, you know, tales of a football player, sexy actress, who you know, drives to the moon in a car or something like that. But, that's certainly not to inform people. In fact, it's to keep people uninformed.*

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[38] Examples on the waterfront are mentioned in Richardson D (2013) 'Corporate power in Australia' paper given to the Sydney Heterodox Economists Conference, December

[39] Australian Government Competition Policy Review (2014) *Issues Paper*, p. 8

> *The goal of advertising is to create uninformed consumers who will make irrational choices. Those of you who suffered through an economics course know that markets are supposed to be based on informed consumers making rational choices. But industry spends hundreds of millions of dollars a year to undermine markets and to ensure, you know, to get uninformed consumers making irrational choices.*[40]

Advertising raises a host of issues as this passage suggests and we begin by looking at the significance of advertising in Australia.

We can get a bit of an idea of the significance of advertising using data from the Australian Taxation Office. Publically available data shows that in 2008-09 companies that were classified as ‘advertising services’ and ‘market research and statistical services’ had a total income of $7.1 billion and $1.4 billion respectively.[41] In addition total corporate income from ‘newspaper publishing’, ‘radio broadcasting’ and ‘television broadcasting’ should give a good proxy for spending on advertising in the media. That comes to a total of $14.6 billion or roughly 1.2 per cent of GDP or 2.2 per cent of final consumption expenditure.[42] Advertising is of course involved in many other industrial classifications. For example, much of the income of the groups of companies called ‘internet publishing and broadcasting’, ‘motion picture and video activities’ and ‘sound recording and music publishing’ would be sales of advertising services.

Many of the apologists for big business and advertising would point to the information content of advertising and deny that it goes beyond providing information. However, the economics of advertising distinguishes between ‘promotional hype’ and the provision of genuine information and shows when different sellers are likely to use one or the other strategy.[43] Here we refer to these as type 1 and type 2 advertising. In this treatment promotional hype is the traditional persuasive advertising relying on image. It ‘promotes any feature that is unambiguously valuable, or otherwise increases the willingness to pay of all consumers; it shifts the demand curve outwards’. But this type of advertising tends not to go into detail lest it thereby deter some consumers. On the other hand, type 2 advertising provides real information ‘allows a consumer to learn of his personal match with the product’s characteristics’.[44] This type of advertising is often seen in niche markets although Johnson and Myatt point out that type 2 advertising necessarily includes elements of type 1.

Of course the fact that this type of advertising is providing real information does not make it immune from the Galbraith critique that advertising creates a false demand.[45] Boutique shops advertising their range of ‘Gothic’ clothing designs are hardly catering to an intrinsic human need. The point is that advertising remains part of a symbiotic process that can involve engineering tastes along with product designers, R&D departments, marketing people and so on.

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[40] Chomsky N (2008) ‘What next? The elections, the economy, and the world’, *Audio transcript*, 24 November.

[41] Australian Taxation Office (2011) *Taxation Statistics 2008-09*, 6 April, at http://www.ato.gov.au/corporate/content.aspx?menuid=49810&doc=/content/00268761.htm&page=9&H9 accessed 24 May.

[42] The raw figures are $9.3 billion, $0.4 billion and $6.0 billion respectively (ATO, 2011). However, the income for newspapers was reduced by deducting an estimate of household spending on newspapers based on the ABS 2003-04 household expenditure survey (ABS, 2006) and adjusting for the increase in prices since then using the newspaper and magazine index of the consumer price index (ABS, 2011). The remaining income should be almost entirely due to sales of advertising ‘space’.

[43] Johnson JP and Myatt DP (2006). ‘On the simple economics of advertising, marketing, and product design’, *American Economic Review*, Vol 96, No 3,June, pp. 756-784

[44] Johnson JP and Myatt DP (2006). ‘On the simple economics of advertising, marketing, and product design’, *American Economic Review*, Vol 96, No 3,June, p. 757

[45] Galbraith JK (1958) *The Affluent Society*, Harmonsworth: Penguin.

The argument here can be regarded as an extension of the Hotelling argument; a monopolist will attempt to 'catch' both the median consumers plus those with extreme/unusual tastes. Indeed Johnson and Myatt show that the very design decision is likely to reflect the firm's estimation of whether it will benefit from a strategy that produces a wide dispersion of tastes or a convergence of tastes around a narrow spectrum. The persuasive role of advertising may deter the entry of competitors in a market. Consumers can be reluctant to try new products and heavy advertising by the incumbent firm acts to reinforce consumer bias against new and unknown products.[46]

The problems of monopsony and oligopsony

> *Australia is evidence that there comes a tipping point when these retailers reach a position of dominance. By leveraging their enormous customer bases, Coles and Woolworths have managed to turn themselves into grocery providers, newsagents, bakers, butchers, liquor stores and petrol stations. If their lobbying proves fruitful, they could soon become banks and pharmacies. Long before it became obvious, Coles and Woolworths had seized effective control of the entire supply chain. Supplier power twisted into buyer power, and the retailers began to influence the size and shape of just about every industry in Australia. This high degree of retail concentration has thrown up many challenges. Ugly, anticompetitive behaviour has been aired in Australian courtrooms, and various forms of public interest protection – litigation by the regulators, a Retail Code of Conduct, unconscionable conduct provisions – have been hurled at the retailers with limited success*.[47]

This is not the rantings of an anti-business zealot but part of a conclusion in a learned article by Allan Fels.

Most of the discussion in this submission looks at the impact of the lack of competition on consumers. However, big business is also often accused of exploiting its suppliers. The small business sector regularly complains that they are paid late, are expected to offer big discounts and are subject to arbitrary changes in contracts and so on.

People tend to be familiar with the terms monopoly and oligopoly but less so with 'monopsony' and 'oligopsony' 'Monopsony' is characterised by a single buyer of a good or service. The monopsonist is able to pick of suppliers against each other and the latter are in no position to exercise what Galbraith referred to as 'countervailing power'.48 Oligopsony is analogous to oligopoly. As monopsony is the buying equivalent of a monopoly seller, so oligopsony is the buying equivalent of a market comprised of oligopolistic sellers. In the same way as oligopolies exploit customers so do might oligopsonies exploit suppliers.

In the US Walmart is regarded as a monopsony in certain market segments where its buying power for a specific item is a significant part of the market. In Australia Coles and Woollies are the equivalents. Coles (a subsidiary of Westfarmers) and Woolworths have been gradually increasing their share of the market. In 1975 Coles had 18 per cent of the market and Woolworths had 16 per cent.[49] Other retailers had a total of 67 per cent—two thirds of the market! Since then Woolworths has grown to reach 46 per cent of the market while Coles

[46] Bagwell K (Ed)(2001) 'Introduction' *The economics of Advertising*, Cheltenham, UK: Edward Elgar.
[47] Fels A (2009) 'The regulation of retailing – lessons for developing countries' Asia Pacific Business Review, Vol. 15, No. 1, pp. 13–27, p. 25.
[48] Galbraith JK (1952) *American Capitalism: The concept of countervailing power*, Harmondsworth: Penguin.
[49] Figures in this paragraph are from Australian Food and Grocery Council (AFGC) and A.T. Kearney Australia (2011) *2020: Industry at Crossroads*.

has 32 per cent. Other retailers share 22 per cent of the market, of which IGA has 14 percentage points.

According to a recent global study of retailers by Deloitte, a consulting firm, Australia had two retail companies among the top in the world and were ranked 18th and 21st in the world by sales values in 2010. In order to make international comparison we need to scale the retailers' figures to the size of the economy where they are located. That is done in Table 3which gives the turnover of the top two retailers in a selected group of countries. Turnover is given both in absolute terms in US$ as well as a share of GDP which gives a more meaningful picture.

Table 3: Top two retailers' turnover, selected countries

	Turnover of top two retailers, US$ billion	As share of GDP, per cent (%)
Sweden	47	10.01
Australia	100	8.04
Switzerland	38	6.90
France	175	6.81
UK	125	5.51
Germany	168	5.07
US	501	3.46
Spain	38	2.73
Canada	41	2.60
South Korea	22	2.17
Japan	110	2.00
Italy	28	1.36
China	25	0.42

Source: Deloitte (2012) Global Powers of Retailing, 2012 and IMF (2012) World Economic Outlook Database.

These results show that Australia's two big retailers loom very large in the Australian economy relative to the other countries chosen here. Australia's big two come in at eight per cent of GDP on the Deloitte figures. The only higher country in the list was Sweden where the top two retailers' sales are ten per cent of GDP. These figures suggest Australia has one of the highest levels of concentration in the retail sector.

Squeezing farmers

While the practice of retailers putting suppliers under enormous pressure is not restricted to any one sector we illustrate the practice with an example from the fresh food sector. According to Australian Bureau of Statistics (ABS) input output tables the Australian wholesale and retail industry adds a mark-up of 47 per cent on fresh food.[50] Most people

[50] ABS (2010) *Australian National Accounts: Input-Output Tables–Electronic Publication, Final release 2006–07*, Cat 5209.0.55.001. No. 23, December 2010.

would be surprised at that since the results of a survey conducted by The Australia Institute showed that people would have expected the mark up on fresh food to be 19 per cent on average.[51]

Despite the views of Alan Fels reported in the opening of this section, the duopolists have tried to present themselves as benign players. During the so-called milk wars Coles gave assurances that they would not drive down farm gate prices that were used by the then Agriculture Minister Senator Joe Ludwig to try to mollify the industry. He said 'cheaper milk for consumers should not come at the expense of our dairy industry'.[52] Nevertheless Coles and Woolworths probably have contracts with hundreds of individual producers who once locked into a relationship with a buyer have little real economic power compared with Coles and Woollies. The Australian national food plan under the Labor Government is described as 'giv[ing] short shrift to manufacturers who have been complaining of falling competitiveness and threats posed by Australia's supermarket duopoly' but does say the ACCC is examining those concerns.[53] In the meantime there are continuing reports that Coles and Woollies continue to put price pressure on all suppliers including farmers.

For example, the price wars between Coles and Woollies seem not to reflect the duopolists taking fewer profits themselves but a competition about who can squeeze their suppliers the most. For example Woollies is reportedly squeezing 'price cuts from scores of suppliers to help fund its price war with Coles - and buyers from the supermarket giant have threatened to remove products from the shelves if the demands are not met … a number of suppliers have been given two weeks to find cost savings of between 5 and 10 per cent, or face being removed from the aisles'.[54] It is difficult to get more information because suppliers are naturally reluctant to accuse the buyers of inappropriate behaviour for fear of retaliation. However, it would be naïve to think the average supplier can bargain with Coles and Woollies as equals.

From time to time the market structure of the sugar industry also becomes an issue. While the bulk of CSR Limited's sugar sales go through Coles and Woollies, CSR in turn puts downward pressure on its suppliers, the sugar growers. Sugar is indicative of many of the other agricultural markets.

While there is competition between farmers, there is typically a monopsony buyer who is in a very powerful position vis-à-vis the growers. The monopsony power derives from the physical characteristics of cane growing. Cane growers set up around a mill which is serviced by a radial network of rail links between the growers and the mill. Cane is a bulky commodity with low value relative to the transport costs. It is generally not worth carrying over significant distances or on alternative transport networks. Nor is it feasible or worthwhile setting up alternative rail or other transport linkages in competition with the existing transport infrastructure (see below).

The Productivity Commission (PC) points out that cooperative ownership is a form of "vertical integration" which, in turn, is a "common strategy used throughout industry to overcome the potential problems associated with two highly inter-dependent sectors."[55] However, the PC also seems to assume that the establishment of a cooperative venture would be viable in the

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[51] Irvine B, Richardson D, Fear J and Denniss R (2011) *The rise and rise of online retail*, The Australia Institute technical brief no 8, May

[52] Hepworth A (2012) 'Milk wars "may kill off farms"', *The Australian*, 2 March.

[53] Roberts P (2012) 'Food planners sweet with retail duopoly' *The Australian Financial Review,* 18 July. http://www.afr.com/p/national/food_planners_sweet_with_retail_NR2DFupTpwf5FrwFEyAIEK

[54] Hawthorne M and Heffernan M (2012) 'Suppliers squeezed: Wooolies accused', *The Canberra Times*, 6 July.

[55] Productivity Commission (1999) *Submission to the Sugar Industry Review Working Party*, August.

presence of existing mills. It is naïve to think that the existing mill-owner would not be taking action to undermine any cooperative mill venture. For example, the cooperative mill could be "killed" by offering growers lucrative contracts for so many years, sufficiently long so that the new mill would get no throughput. Alternatively there may be some form of blackmail against growers expressing an interest in alternative mills. Nevertheless, the PC does seem to be on solid ground if the cooperative mill is offered as an alternative to the existing status quo in CSR's mill areas.

The PC also seems to think that even in the Burdekin, where it admits all the mills are owned by the same company (CSR), "there will be little scope for mills to exercise economic power over the longer term because of the threat of new entry." It spells out how that would work by continuing "[I]f mills force up crushing charges to inflate profits, they will attract new entry [on the part of other mills]. This will compete the price of crushing services down to competitive levels. The PC also thinks that new mills would be encouraged by abolishing the assignment system.

This thinking relies on the old contestability hypothesis which said that if someone in an industry is earning abnormally high profit, others will be attracted into that industry to contest the profits of the initial producer. Competition will drive profits down to more normal levels. Further work has demonstrated that the proposition relies on very unrealistic assumptions. In particular the contestability hypothesis relies on costless entry and exit into the industry on the part of new contestants. In the case of sugar mills it would require that someone could set up a new mill, and, if the venture failed to make at least normal profits, get out of the industry again without incurring any losses on the total exercise. If costless entry and exit is not assumed then the likelihood of failure will deter potential entrants. The assumptions only have to be stated to show their weaknesses. Existing mill owners would have more than sufficient time to recognise a potential rival in the market and take evasive action so that the rival would no longer be attracted into the industry.

Last year there was a proposal by foreign interests to take over GrainCorp which is an important grain handler and buyer/trader. Eventually the Treasurer Joe Hockey prohibited the proposed acquisition by American company; Archer Daniels Midland Company (ADM. For many farmers GrainCorp was the only buyer. It used to be the NSW Grain Handling Authority until the latter was privatised in 1992. Deputy Prime Minister, Warren Truss, is reported to have said that 'If we lose [GrainCorp] to foreign ownership then we will lose the potential to have an international standard agribusiness'. He has also suggested that Australia would lose control of its food security. Other critics point to GrainCorp's virtual monopoly on the east coast. GrainCorp made a healthy 14.4 per cent rate of return on equity in 2012 (the latest figures available before the decision). That 14.4 becomes a 21.5 return on equity before tax, a very healthy return which is likely to reflect some market power. Adjusting for the intangible or fictitious assets the pre-tax return on equity increases to 28.3 per cent. On these figures GrainCorp was a very attractive and very profitable target.

Intellectual property (IP)

The issues paper effectively says that inventors need incentive to create new products and processes. That has certainly been the rationale for effectively shielding inventors from competition. However, the monopoly over a product or process can be used by the patent holder to prevent other people accessing the knowledge on reasonable terms. The important thing is that there is a trade-off between incentive to innovate and the need to avoid monopolies.

Stiglitz has argued that we can think of knowledge as a pool and it is true that the incentive to create may increase the knowledge being generated at any one time. However, genuine creation whether by invention or otherwise is never completely new but instead involves incremental steps in the generation of knowledge. While strong IP rights may increase the incentive to put into the pool (thereby generating positive externalities) they hamper the ability to take previously generated knowledge out of the pool (giving rise to negative externalities). The design of the rules is therefore important. As Stiglitz says:

> *The exercise of intellectual property rights, diminishes the size of the pool available to others. At the same time, each innovation that is not patented may contribute to the pool of ideas that others can build on.*[56]

Stiglitz also points out that many European countries with weak property rights nonetheless had 'flourishing innovative sectors'. The present US system is characterised by 'patent thickets', 'holdups' and other problems for those who want to develop existing ideas with the consequent deterring of innovation. The US example is particularly important since the US is trying to extend its own brand of IP rights into other countries. The Howard Government successfully resisted some of the American attempts to strengthen IP rights but agreed to others, such as extending the length of copyright protection.[57]

The US has been able to persuade other countries to include IP rights in trade negotiations with one outcome being the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) under the auspices of the World Trade Organisation. In addition the coverage of IP rights has extended into new areas such as software and genetic material. Since TRIPS, the US has engaged in a series of free trade agreements in which it has promoted stronger IP rights than provided under TRIPS.

The PC found that Australia is a net importer of goods and services incorporating IP which means Australia would lose more than it gains by strengthening IP rights. In Stiglitz's terms Australia would be less likely to contribute to the pool but would find it harder to take from the pool. The net economic impact is thus likely to be negative.

A full discussion of patents and similar 'protections' would take us too far afield and the committee is unlikely to want to make detailed recommendations. However, it is the view of this submission that the committee should express an in-principle view that patents and similar protections should be wound back unless there are compelling reasons in specific instances. In particular the committee should recommend a critical examination of the tendency in recent decades to make it easier to take out a patent on such things as software and business methods that hardly fit the old fashioned standards to do with originality and non-obvious discoveries.

A particular issue that has been recently highlighted is the use of technical measures to enable companies to practice price discrimination. Manufacturers of DVDs divide the world into four regions and have an agreement with the manufacturers of DVD players so that the players on sale in different regions can only play the DVDs intended for that region. This agreement prevents consumers in Australia buying DVDs from the US and other regions. The consequence is that sellers exploit some region relative to others so that, for example, new DVDs cost substantially more in Australia than in the US. An earlier study by The Australia Institute showed that DVDs in Australia tend to cost about twice the US price.[58]

Things have gradually improved recently. Sony, a multinational equipment manufacturer and content provider, took legal action against a supplier of Sony PlayStations who modified

[56] Stiglitz JE (2014) Intellectual property rights, the pool of knowledge, and innovation', *NBER Working papers series, no 20014*, March.

[57] Much of what follows is taken from Richardson D (2004) Intellectual property rights and the Australia-US free trade agreement, *Parliamentary Library Research Paper No 14, 2003-04*, 31 May.

[58] Richardson D (2013) 'The remaining agenda for free traders', *Online Opinion*, 23 May.

them so that those players could play discs from any region. The high court ruled that the practice was not illegal since the technology measure infringed the right to enjoy something that people can legally purchase and people were allowed to overcome those measures.[59]

While the High Court's decision is to be welcomed most game and DVD players sold in Australia still impose regional restrictions on what the consumer can play. A pro-competition position would seem to demand that any measure that prevents an Australian enjoying a legal product purchased overseas should be illegal in Australia. People selling machines and content in Australia should be prevented from using any artificial measure that restricts free trade. The regional and other restrictions on the consumer right to enjoy something purchased legally should be a matter to be pursued in world trade forums. There are other restrictions that large international companies impose which have the effect of impeding trade. For example, Amazon refuses to sell some MP3 content outside the US market. Practices that would be illegal within many individual markets are presently able to be practiced <u>between</u> markets.

This submission also suggests the committee should be very wary of any arguments in favour of extending IP in considering competition issues and instead should encourage governments to take steps to reduce protection for the more trivial claims. There should also be a way of overcoming the tendency for dodgy patents and legal delays to be used to give particular companies a competitive advantage as in the release of new mobile smart phones.

Copyright protection raises similar issues. The Australia US Free Trade Agreement extended the duration of copyright by 20 years. The US extended copyright protection from 50 years to 70 years in 1998 with the passage of the Sonny Bono Copyright Extension Act 1998. Apparently the main motivation for the extension was that Disney's rights to Mickey Mouse were due to expire in 2003.[60] By now Mickey Mouse would have been in the public domain, there would be genuine competition in the supply of the Mickey Mouse products and the use of the image in other works.

Some owners of copyright have a large library of old but valuable product: the Disney Corporation is obviously one of them. They have an interest in extending their rights as long as possible, but would be hard pressed to argue that they need that sort of incentive to produce new work. Their motivation is to retain and reinforce the monopoly they currently enjoy. It goes without saying that the idea that there is an actual benefit to an individual from anything that might happen 70 years after death is unconvincing.

This submission suggests the committee in considering competition issues should be very wary of any arguments in favour of extending IP and instead should encourage governments to take steps to reduce protection for the more trivial claims. There should also be a way of overcoming the tendency for dodgy patents and legal delays to be used to give particular companies a competitive advantage as in the release of new mobile smart phones.

Education, health and disability care and support

The issues paper invites submissions to consider the question:

[59] High Court of Australia (2005) Eddy Stevens v Kabushiki Kaisha Sony Computer Entertainment and others, 6 October

[60] OECD (2004) *Patents and Innovation: Trends and Policy Challenges*, OECD, Paris, p. 23.

> *Would there be a net public benefit in encouraging greater competition and choice in sectors with substantial government participation (including education, health and disability care and support)?*[61]

Elsewhere the issues paper suggests that it is desirable that various human services such as health, education and others should be 'innovative, cost efficient and responsive to consumers'.[62] No evidence is presented to suggest this is not already the case and in fact we are concerned that competition in some of these areas can be perverse.

Health

In the health area there is competition to mainstream health services from a host of related services from chiropractors through to faith healers and a host of products from useless vitamins through to ancient and ethnic remedies as well as homeopathy alternatives. Even within mainstream health services there is often competition from providers who have falsified their qualifications. On top of all that are beauty and quasi-therapeutic services which are not always harmless. And we should never forget that radiation was early promoted as a way to lose unwanted hair and petrol was once promoted as a health product (before the internal combustion engine provided a better use).

Fred Hilmer used the analogy (borrowed from George Stigler) that competition is a 'tough weed' and added that 'tough weeds find even small cracks in the pavement to break through'.[63] Hilmer is no doubt correct. Health and related services are ripe for quackery of all kinds and there seem to be a never ending series of weeds that appear and blight the health pavement to continue the analogy. It is vital that governments protect the vulnerable especially when only the 'experts' can really judge the merits of the various products on offer.

The market model relies on perfect knowledge on the part of the consumer who is assumed to be able to assess the consequences of buying particular products. The asymmetry of knowledge is a major cause of market failure in many markets which is of course the classic argument for government involvement. But with health in particular the implications of market failure are especially concerning.

On the other hand leaving issues such as immunisation to the market has serious consequences for the rest of us. If I get immunised there is still a risk I may be affected if I come in contact with an afflicted person but if we are all immunised then we reduce the probability of the latter happening.

Education

We have seen exposés of the private training industry in the building trades whereby qualifications are given but the training is either under-provided or virtually non-existent. Likewise there is evidence of English language instruction for foreign students being under-delivered. In such cases there is often an implicit conspiracy between the provider who wants to under-deliver and the client who is happy to accept the qualification without doing the work.

Students have been known to bribe teachers and lecturers.[64] This is an extreme example of how competition works in the education system. Less severe forms include allegations that

[61] Australian Government Competition Policy Review (2014) *Issues Paper*, p 24.
[62] Australian Government Competition Policy Review (2014) *Issues Paper*, p.3.
[63] Hilmer F (2014) 'New technologies will crack flawed NBN model', *The Australian Financial Review*, 28 April.
[64] The author has had personal experience although only to the extent of deliberately ambiguous hints which were not followed up.

private training providers skimp on the education actually provided and the trainees are often happy to get the qualifications without having to complete all the work. Education should involve instruction on the one hand, study on the other hand and then certification as the outcome. It is in the self-interest of the supplier and the ‘buyer’ respectively to under-perform and so the market solution is likely to produce a result at odds the objectives of education. It might be suggested that education is a dangerous area to attempt to develop a true market.

It may be possible to develop a strong regulatory oversight to keep in check the incentives to cheat. However, in that event the costs to society of our education system would include not just the cost of private provision but as well there is the cost of the regulatory structure to oversight the private providers. The traditional solution is for governments to provide in a context that avoids the incentives to cheat on the system and includes self-regulation through peer review and the like. There have to be very good reasons to depart from the traditional mode of delivery.

The committee should make it clear that competition should not be introduced in those markets unless it can be established beyond doubt that there will be no unintended consequences.

Policy implications

Those tempted to experiment further with pro-competition and pro-market reforms need to be reminded of the conditions under which competition can work. These are spelt out in the better economics textbooks and include perfect knowledge, perfect foresight, a large number of both buyers and sellers, independent tastes, zero transactions costs, and all contracts are completed. It goes without saying that these conditions are never filled in practice. People regularly spend billions of dollars on various forms of quackery because the conditions under which competition can be effective are violated by consumer ignorance and persuasive advertising.

In our work on banking[65] The Australia Institute has made the point that competition as a policy can be traced back to at least the mid-1800s and is regularly trotted out as the appropriate response. Despite that banking remains a very uncompetitive industry characterised by excess profits. We argued that policies that attempt to foster more competition are going to be impotent when the market characteristics work against competition as a strategy. In fact it could very well be argued that the present incumbents in the banking system, especially the big four, are in fact the winners. Since the Bank of New South Wales (later Westpac) was established in 1817 there have been many competitors but the technology favours the incumbent. Economies of scope and scale as well as network effects mean that the incumbents are pretty well immune from serious competition. Arguably much of the rest of Australia’s industries are similar to the banks in that there are forces that favour a small number of incumbents.

Uncompetitive markets pose a dilemma for governments. Competition policy is relatively easy. Mechanisms are put in place or regulations removed so that competition is encouraged and in principle governments do not have to do anything else. In particular they do not have to monitor and regulate private behaviour in the public interest.

If as argued in this submission the subsets of the economy where competition policy is likely to work are relatively small then competition policy designed to soften the ‘evils’ of big business or promote the benefits of competition will necessarily be ineffective. That is certainly true of the big four banks whose profits as a share of GDP are now at a post war

[65] Richardson D (2012) *The rise and rise of the big banks: Bank ownership concentration, monstrous balance sheets and profit*, June.

high despite our history of competition from the building societies, credit unions, foreign banks, mortgage originators together will deregulation and privatisation. But it is equally true in retail, construction and the other industries in

Table 1 above.

Indeed the variant of competition policy that does seem to have worked from time to time was competition from government enterprises and member-owned organisations. For example State banks in South Australia, Tasmania and Victoria and later the Commonwealth Bank were intended to keep the private sector honest and seem to have had that effect, at least until they were privatised. Likewise there is evidence that NRMA insurance had the effect of keeping prices down for general insurance when it was mutually owned.[66] Member-owned super funds seem to have much lower fees and better returns than the for-profit funds.[67] The committee should note the non-profit sector including mutually owned enterprises and consider how the government might foster these types of organisations so as to provide better alternatives for Australian consumers.

In some areas competition policy may simply be impotent. For example, we have seen over a century of banking policy based on competition with little impact. Likewise, some corporate regulation seems to be inspired by the notion that there is an efficient market in the ownership and control of modern corporations. In response to the very high salaries going to the CEOs of Australia's large corporations the law was changed to give shareholders greater rights to reject remuneration reports. That may have had limited success but the major factor in slowing down executive pay seems to have been the public outrage at executive pay that we witnessed in the mid-2000s.

If incorrectly or inappropriately applied there is the risk that competition policy can be perverse. Because the conditions required for competition to work are so restrictive the policy maker has to decide whether the actual circumstances are close enough to ideal or can be made close to ideal in which case competition can then be relied upon. For example food labelling now means that consumers have access to pure fruit juice without additives as well as juices that are not much more than cordials. There are a range of juices with varying degrees of nutrition. However, that was not always the case. Prior to changes in labelling requirements there did not seem to be much of a range in juices, all claimed to be healthy and prices were fairly uniform. However, competition had driven the market towards producing at lower prices and with lower standards yet the products were misrepresented as healthy fruit juice.

Where there are examples of markets in which competition fails as a policy, governments have to intervene directly in the market to ensure socially desirable outcomes. Milton Friedman noted that in the event of economic power through monopoly 'there is only a choice among three evils: private unregulated monopoly, private monopoly regulated by the state, and government operation.'[68] Friedman suggested the least bad option was government operation. However, Australia and most of the world have often opted for private monopoly regulated by the state. That seems an attractive alternative and is often promoted as giving us the best of both worlds.

Conclusions

The arguments in this paper could be read as a series of anecdotes that mean occasionally competition policy may not be the best answer. Many analysts regard monopoly, oligopoly and other imperfections in the economy as raising serious issues but nevertheless treat the economy as a whole as if it conformed to our notions of perfect competition. Monopolies and oligopolies are treated as if they are minor exceptions. For example the Productivity

[66] Richardson D (2014) *Submission to the financial services review*, March
[67] Richardson D (2014) *Submission to the financial services review*, March.

[68] Friedman M (1962) *Capitalism and Freedom*, Chicago University Press.

Commission's core work is to examine bits of the economy where things many not be working as well as they should. Yet the PC assumes perfect competition in its general equilibrium modelling.[69] Our discussion in this submission has pointed out that most sectors of the Australian economy are uncompetitive and that is demonstrated by their very high profitability. Rather than treat imperfect competition as the exception, it might be more accurate to treat competitive markets as the exception and imperfect competition as the rule.

Milton Freidman suggested that the best or least bad policy in the case of a natural monopoly was public ownership. The history of electricity 'reform' shows Freidman was right. Instead of the industry being managed by a few engineers whose job was to deliver electricity to consumers we now have a number of institutions who wheel and deal on the wholesale market and employ a sales force to compete with each other using non-price competition. Costs are padded and passed by a compliant regulator.

Australia has now pursued a micro-reform agenda for decades and many of the easy or obvious reform initiatives have been taken up. The remaining areas are those where the application of competition policy is much more problematic or inappropriate. This submission suggests that the remaining areas are limited. However, that does not mean the absence of areas in need of reform rather the sort of reform needed is not necessarily associated with competition principles. For example, some of the important international trade issues no longer concern questions of protectionism and other government imposed restrictions on trade. Rather the concern is increasingly the role of the multinational corporation and its ability to practice price discrimination between regions or nations.

[69] Without that assumption other features of their modelling would not work. For example, the models assume factors of production, labour and capital, are paid their marginal products which is not the case outside a very competitive world.

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