
ARTICLES

SIZE DOES MATTER: THE EFFECTS OF MARKET SIZE ON OPTIMAL COMPETITION POLICY

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CHAPTER 1: INTRODUCTION

In the past two decades the number of jurisdictions that have adopted or are contemplating adoption of a competition policy has grown exponentially. Twenty years ago there were approximately twenty jurisdictions with competition laws. As of the millennium, there were approximately ninety jurisdictions with competition laws, and this number continues to rise. Many of these jurisdictions are small in size. For the most part, the jurisdictions with new competition policies adopt the competition policies of larger ones, especially the European Union (EU). The adoption of the competition policies of large jurisdictions has many benefits for small jurisdictions including the following: a wide base of ready-made law that is frequently updated (i.e. learning and network externalities); reduction of trade obstacles; and savings in adaptation costs. The economic paradigms on which such competition policies are based,

however, do not necessarily apply to small market economies. This article argues that the size of a jurisdiction's market significantly affects the competition policy that it should adopt. It then proposes general policy prescriptions for the adoption of optimal competition policies in small economies.

1.1 DEFINITION OF A SMALL MARKET ECONOMY

For the purposes of this article, a small economy is defined as an independent sovereign economy that can support only a small number of competitors in most of its industries when catering to demand.¹ This definition captures some of the economic consequences of size that affect the efficient formulation of competition policy.

Market size is influenced by three main factors: population size, population dispersion, and openness to trade. Large population size increases demand and enlarges the number of firms that can efficiently serve the market. Population dispersion over a large geographic size may create market regionalization through several small local markets within a larger jurisdiction.

Market size is also influenced by a combination of economic, geographical, technological, legal, and political factors that create market boundaries and restrain the entry of potential competitors. Primarily, the relevance of the jurisdiction in economic analysis is dependent on the international environment in which it is placed, including its trade agreements or arrangements with other economies with which it has actual or potential economic contact. A liberal trade policy or a common market policy may tend to eliminate some of the discontinuity of economies at frontiers, and may make the jurisdiction *de facto* less relevant as a unit in economic analysis.²

In most cases, however, trade policy cannot or does not remove all trade boundaries. For example, liberal trade policies cannot erode language differences, where language is an important part of the product (e.g., computer keyboards). Trade barriers also may result from geographic

1. In economic terms, market size is defined as the ratio of the output that would be demanded at a price just sufficient to cover minimum unit costs, to the size of a unit of production that is just sufficiently large to achieve lowest average costs of production.

2. Some political units are economically integrated into larger ones so effectively that the degree of real discontinuity is negligible. For example, Monaco's integration into France, Andorra's integration into Spain, and the Vatican City's integration into Italy make their jurisdictional borders irrelevant to the analysis.

boundaries (e.g., maritime borders, high mountain chains, or secluded areas) that create high transportation costs. Transportation or adaptation costs affect trade levels, especially where low price, high shipment costs, or perishable products are involved.³ Trade is also limited where producers must be in close proximity to the ultimate consumers (e.g., service industries). Political conditions may also influence trade levels—accentuating geographic isolation both by closing certain passages to trade and by preventing trade between adjacent jurisdictions.

Tariffs, limited convertibility of currencies and transfer of credits, and a central authority's standardization of consumer choice also create trade barriers. Moreover, trade levels are affected by domestic laws and regulations, such as those regulating environmental liability and intellectual property rights. Trade intensity may also be affected by entry barriers that face domestic and foreign producers alike, such as brand name recognition. Accordingly, where significant natural or artificial barriers to trade exist, the size of the domestic population and its dispersion significantly influence the economic conditions of the market.

The definition of a small economy is arbitrary in the sense that there is no "magic number" that distinguishes a small economy from a large one. Rather, jurisdictions can be placed upon a continuum according to their size. Some jurisdictions are very small, such as Faro Islands (with a population of approximately 40,000), Jersey (90,000), and Malta (350,000). These are geographically small island states, as is New Zealand. Israel also can be considered an island economy, due to political reasons, but is much larger with a population of approximately six million.

Australia is much larger but can still qualify as a small economy because most of its industries are characterized by concentrated market structures. The population is dispersed over large geographic areas but concentrated around several urban centers. This creates market regionalization that, in turn, creates typical problems of small markets—especially highly concentrated industries. Prior to the reduction of trade barriers due to NAFTA⁴, Canada was also a highly concentrated market, for reasons similar to those in Australia.

3. Australia's distance from major exporters, for example, is large enough to make natural protection quite substantial for some products. See Richard E. Caves, *Scale, Openness, and Productivity in Manufacturing Industries*, in *THE AUSTRALIAN ECONOMY* 313, 313 (Richard E. Caves & Lawrence B. Krause eds., 1984).

4. North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., Parts One-Three, 32 I.L.M. 289, Part Four-Eight & Annexes, 32 I.L.M. 605 (1993)(entered into force Jan. 1, 1994).

It should be emphasized that in order to be considered small, not all industries in a particular economy should be highly concentrated. Some industries, such as retail services, are highly competitive even in small economies. Conversely, firms located in small economies might compete and even control world markets. In such cases, the size of the domestic market does not constrain the scale and scope of production. Nonetheless, where such firms are the exception rather than the rule, the jurisdiction should still be defined as a small economy.

1.2 THE NEED FOR A SPECIALLY TAILORED COMPETITION POLICY

Small economies need a specially tailored competition policy, because they face different welfare maximization issues than large ones. The size of some industries can be suboptimal in some markets because limited market demand constrains the development of a critical mass of domestic productive activities that are necessary in order to achieve the lowest costs of production. Because of scale economies and high entry barriers, small economies cannot support more than a few competitors in most of their industries even where productive efficiency can be achieved. The prevalence of concentrated market structures adversely impacts price, output, and research levels of many goods and services, with knock-on effects where they are also inputs in production. Therefore, in the small economy, achieving and maintaining a balance between permitting firms to be large and integrated enough to enjoy scale economies, as well as numerous enough to ensure effective rivalry, is challenging.

These salient characteristics have important policy implications, as they require small economies to devise appropriate endogenous policies that offset at least some of the adverse effects of small size. The main factor that creates the need to tailor competition law to economic size is that competition laws generally consist of “fit all” formulations that are designed to best achieve the goals of the law in each category of cases to which they apply (e.g., mergers, cartels, or dominant position), while recognizing that some false positives and false negatives occur at the margin.

The marginal cases of large economies, however, constitute the mainstream cases in small economies, as small size multiplies the existence of highly concentrated markets protected by entry barriers. Thus, the effect of small size resembles a magnifying glass: special market phenomena are highly significant as extremes become the rule. Therefore, the large market competition policy paradigm is ill-equipped to contend with the needs of

small economies. Consequently, small economies must change the focus of their competition laws in order to regulate their markets efficiently.

Moreover, in small economies, an appropriately structured and efficiently enforced competition policy may be more important than in large ones. Since the market's invisible hand has a much weaker self-correcting tendency in smaller economies, the costs of competition laws that are improperly designed and applied might be greater both in the short and in the long run. The conduct of market players should thus be regulated to ensure both that competition takes its course in those industries where competition is feasible and that limits are imposed on the conduct of firms operating in markets that are not fully self-regulating.

Many of the principles and doctrines that apply to large jurisdictions apply equally to small ones. The goals of competition policy—creating and maintaining the conditions for workable competition in order to maximize social welfare—and its main tool and ideological choice—a market economy—are similar in both small and large economies. Yet, the comparative prevalence of concentrated market structures in small economies creates a set of tradeoffs that require a different set of rules to regulate the conduct of market participants efficiently.

There is no doubt that openness to trade is a primary solution to many of the problems that small size creates, because it enlarges the scope of the market. Yet competition policy plays a crucial triple role in regulating market activity. First, competition policy facilitates trade by reducing barriers to both foreign importer entry and domestic product exports. Second, competition policy plays a critical role where unrestricted exposure to international trade is not sufficient to solve a small economy's efficiency problems. Third, where artificial trade barriers are not reduced, competition policy is a second-best alternative for regulating closed or semiclosed small markets.

1.3 THE IMPORTANCE OF EVALUATING THE IMPLICATION OF SMALL SIZE

Although several major studies have focused on the special characteristics of small economies,⁵ there is no comprehensive attempt to evaluate the implications of those characteristics on regulatory policies—

5. See, e.g., *ECONOMIC CONSEQUENCES OF THE SIZE OF NATIONS* (E.A.G. Robinson ed., 1960); *PROBLEMS AND POLICIES IN SMALL ECONOMIES* (B. Jalan ed. 1982) (compiling papers presented at the Conference on Small Economies, Marlborough House, London (June 2–5, 1981)).

especially competition policies—in small economies.⁶ This article begins to fill this void, by providing general policy guidelines for small economies. It places under a magnifying glass the implications of small size for competition policy.

The need for this research has intensified in recent years. Political trends to split large economies into smaller ones and the move toward more market-oriented economies has made competition policy an important and indispensable tool in the formation of new market economies. The shift from direct management of the economy by government to an increased reliance on the market has led to the adoption of competition laws as an integral part of economic reform measures in many jurisdictions.⁷ In addition, only in recent years have many small jurisdictions acknowledged the important role of competition laws in regulating their markets by maximizing the use of the market's invisible hand. These trends increase the need for a study of the implications of small size on competition policy, one of the main economic tools used in market economies.

It should be noted that some of the issues relating to small economies apply equally to small markets within larger ones. These comparable issues occur in three principle situations. First, market conditions may create regional submarkets within larger ones, where the price of products can vary—to a large extent—independent of price elsewhere.⁸ Second, demand conditions in an industry may support the operation of only a relatively small number of firms in national markets. Finally, worldwide monopolistic or oligopolistic market structures may arise.⁹ The inherent

6. Several articles have focused on the effects of small size on particular areas of competition policy, mainly in the area of merger review. *See, e.g.*, Shyam Kemani, *Merger Policy in Small vs. Large Economies*, in *CANADIAN COMPETITION POLICY AT THE CENTENARY 205* (R. Shyam Khemani & W.T. Standbury eds., 1991); David Gilo, *Antitrust Policy in Small Economies* (1994) (unpublished LL.M. Paper, Harvard Law School).

7. The adoption of competition laws and liberal economic policies is associated with the dramatic political liberalization both in Latin America and in the former republics and satellite nations of the Soviet Union. *See* Mark R. A. Palim, *The Worldwide Growth of Competition Law: An Empirical Analysis*, 43 *ANTITRUST BULL.* 105, 111–15 (1998).

8. For example, the U.S. health care industry has many of the characteristics of a small and concentrated market, given the regionalization of its services. This has been acknowledged by the DOJ and the FTC. *See* Department of Justice and Federal Trade Commission Statements of Enforcement Policy and Analytical Principles Relating to Health Care and Antitrust, 4 *TRADE REG. REP. (CCH)* ¶ 13,152 (Sept. 30 1994) [hereinafter *Statement of Policy in Health Care Industry*]. *See also* Gilo, *supra* note 6, at 72–78.

9. *See, e.g.*, Federal Trade Commission, Statement of Chairman Robert Pitofsky and Commissioners Janet D. Steiger, Roscoe B. Starek III, and Christine A. Varney in the Matter of the Boeing Co./McDonnell Douglas Corp., File 971-0051 (July 1, 1997), <http://www.ftc.gov/opa/1997/9707/boeing.htm>, available from FTC Public Reference Branch, Room 130, 6th Street and Pennsylvania Avenue, N.W., Washington, D.C. 20580.

characteristics of these markets are, in many respects, similar to small-scale market economies. Yet the difference in the paucity of concentrated market structures between small economies and large ones implies not only that small economies must deal more frequently with concentrated market structures, but also that policy prescriptions should be based on different general presumptions and thresholds.

The rest of this article is organized as follows. Chapter 2 focuses on the economic characteristics of small-scale market economies. Economic analysis serves to answer two questions that are germane to the debate on small economies' competition policies. First, which market conditions and trade practices are characteristic of small economies, and how often do these economic phenomena occur? Second, how large are the gains and the costs of those market phenomena? The answers to these questions underlie the issue addressed in Chapter 3: How should the competition laws of small economies be designed and implemented, based on their unique economic characteristics? Chapter 4 concludes by analyzing the implications of policy findings on the adoption of large jurisdiction laws by small ones and on the current drive toward the globalization of competition laws.

CHAPTER 2: THE ECONOMIC CHARACTERISTICS OF SMALL MARKET ECONOMIES

Whether firms compete is very much a matter of the natural conditions of the markets in which they operate, and natural conditions are highly influenced by the size of the market. Research has shown that there are three main economic characteristics of small economies: high industrial concentration levels, high entry barriers, and suboptimal levels of production.¹⁰ These characteristics result from the basic handicap of small economies—the large size of minimum efficient scales of production relative to demand. These traits have led some economists to argue that small economies belong to a different class of market economies than large ones.¹¹

10. See discussion *infra* Parts 2.1–2.4.

11. RICHARD E. CAVES, MICHAEL E. PORTER, A. MICHAEL SPENCE, & JOHN T. SCOTT, *COMPETITION IN THE OPEN ECONOMY* 5 (1980).

2.1 THE BASIC HANDICAP:
ACHIEVING EFFICIENT SCALES OF PRODUCTION

The basic handicap resulting from small size is the need to produce at levels that cater to a large portion of demand in order to achieve minimum costs of production. This need creates an entry barrier into the market. An entrant with production at less than minimum efficient scale (“MES”) will face cost disadvantages vis-à-vis firms with MES plants. If MES is large relative to demand, and if the cost penalties for operating below MES are substantial, a new firm would have to enter the market at such a large scale that the combined output of all the firms operating in the market could be sold only at substantially reduced prices—perhaps even below average total cost, unless another firm exits the market. This phenomenon may act as a barrier to entry at the broader enterprise level, where there are economies of firm size encompassing broader organizational economies, .

Scale economies may also affect the choice of technology of firms. Where more efficient production technologies become profitable only after a very large output relative to demand, it might be more profitable to install a different technology that, although less efficient, has lower production costs for the range of output that satisfies demand.¹² Diseconomies of scale may also impede the creation of indigenous research and development, technology acquisition, and technical progress.

The effects of diseconomies of scale may extend far beyond a specific industry if the good or service it provides functions as an intermediate product in the production of other goods. Even if domestic demand for a final product is large enough to provide adequate domestic market outlets for the output of at least one optimum-sized plant, domestic demand may still be suboptimal for the efficient production of equipment, servicing, or other intermediate products necessary for the production of the final product. Accordingly, industrial interdependence greatly increases the scale of the output necessary for the full exploitation of economies of scale.¹³ This basic handicap of small economies results in three main characteristics: high industrial concentration levels, high entry barriers, and suboptimal levels of production.

12. G. Marcy, *How Far Can Foreign Trade and Customs Agreements Confer upon Small Nations the Advantages of Large Nations?*, in *ECONOMIC CONSEQUENCES OF THE SIZE OF NATIONS*, *supra* note 5, at 265, 277–78.

13. T. Scitovsky, *International Trade and Economic Integration As a Means of Overcoming the Disadvantages of a Small Nation*, in *ECONOMIC CONSEQUENCES OF THE SIZE OF NATIONS*, *supra* note 5, at 282–83.

2.2 HIGH INDUSTRIAL CONCENTRATION LEVELS

The relatively large size of MES compared to demand creates high industrial concentration levels in many industries in small economies. Industrial concentration is determined by the number and size of firms operating in it, as illustrated by a simplified example. Suppose a firm has to produce at least 10,000 units in order to achieve lowest costs, and domestic demand is 20,000. The market can economically support only two efficiently sized firms. If demand is only 10,500 the market can support only one efficiently sized firm, a situation called a natural monopoly. When demand is low, fewer efficiently sized production units can operate in the market, creating higher industrial concentration levels. At the extreme, where the MES is larger than the market's capacity, the market can support only one firm or cannot support any firm at all. In most industries, however, a small economy can support a few efficient firms. Barriers to entry can further accentuate this structural characteristic by reducing the rate of turnover and replacement of existing competitors by new more efficient ones.

Studies of industrial concentration levels have confirmed that smaller economies have a smaller number of firms per industry than larger economies. Table 1 compares the industrial concentration levels of the three leading firms in a survey of twelve industries in 1970.¹⁴ The correlation between concentration levels and market size is striking.

14. The data presented in Table 1 were derived from the following sources: F.M. SCHERER, ALAN BECKENSTEIN, ERICH KAUFER & R. DENNIS MURPHY, *THE ECONOMICS OF MULTI-PLANT OPERATION* (1975); MICHAEL SHEFER, *CALCALAT TAASIYA* 4.3.3 (1992) (referencing Israeli data). See also Frederic L. Pryor, *An International Comparison of Concentration Ratios*, 54 *REV. ECON. & STAT.* 130 (1972).

COUNTRY	Market Share of the Three Leading Firms		POPULATION	
	%	Index*	Millions	Index [‡]
U.S.A.	41.1	100	204	100
West Germany	56.1	136	61	129
Britain	60.4	147	55	133
France	66.3	161	51	135
Canada	70.8	172	21	175
Sweden	83.4	203	8	256
Israel	91.0	221	3	480

Table 1: Industrial Concentration Levels and the Size of the Market (1970)

* U.S.A. = 100

‡ The index of the inverted logarithm of the population

Yet, even in small economies, high concentration levels appear only in some segments of the economy. In some industries, such as retail and personal services markets, scale economies are relatively low and thus are capable of supporting numerous enterprises. The structure of these markets is not unique to small economies.

2.3 HIGH ENTRY BARRIERS

Most industries in small economies are also characterized by high entry barriers, i.e., factors that impede or prevent additions of capacity or the entry of new firms into an industry. As noted above, the main entry barrier is created by the need to produce at levels that cater to a large portion of demand in order to achieve minimum costs.¹⁵

Additional entry barriers are created by supply constraints on factors of production. Small population size often constrains the availability of human capital, especially skilled labor. Moreover, most small economies are also small in geographic size, which often implies a limited and less diversified supply of natural, irreproducible resources. The concentration of labor and other economic resources in some economic activities in which the small economy enjoys a marked comparative advantage in world markets (e.g., oil in Kuwait, shipping and fish in Norway)—albeit necessary to overcome the handicap of smallness—emphasizes that few resources are left for other domestically located activities.

15. See *supra* Part 2.1.

Small size may create additional barriers to entry into an industry if existing competitors control concentrated, vertically-linked markets. The existence of high MES levels in one market might create high entry barriers into a vertically-linked market if it requires a new entrant to enter more than one market in the chain of manufacturing and distribution, or if it significantly raises its costs relative to the costs of its rivals.¹⁶ Small size may also make competition too personal, where the business elite is small and is careful not to compete in each other's domain.¹⁷

2.4 SUBOPTIMAL LEVELS OF PRODUCTION

The problems of high industrial concentration levels and high entry barriers is further accentuated by suboptimal levels of production. A recurring observation in studies of small economies is that a considerably large fraction of all output is produced in suboptimal volumes and suboptimal plants, much lower than pure MES considerations would suggest.¹⁸ For example, if demand is 20,000 and MES is 10,000, two firms with 9,000 might operate in the market. Such small-scale operation can have a significant impact on the efficiency and international competitiveness of domestic firms if penalties for such operation below MES are significant. When each plant is smaller or produces a more diverse line of products than do similarly-sized plants in large economies, they employ less specialized equipment, have a higher proportion of setup and downtime costs, and experience fewer of the economies of scale that arise from "learning by doing."¹⁹ Some economists have recognized this as a critical cause of inefficiencies in small economies.²⁰ In contrast, a significant part of the success of many firms in large markets derives from efforts to master the problems of design and production of a quite narrow range of specialized products.

There are numerous reasons for the persistence of small and diversified plants in small markets, such as transportation costs, demand for

16. See H. Armstrong, G. Johnes, J. Johnes, & A. MacBean, *The Role of Transport Costs As a Determinant of Price Level Differentials Between the Isle of Man and the United Kingdom, 1989*, 21 *WORLD DEV.* 311 (1993).

17. Scitovsky, *supra* note 13, at 286.

18. For the seminal work on the subject, see H.C. EASTMAN & S. STYKOLT, *THE TARIFF AND COMPETITION IN CANADA* 13 (1967). See also Melvyn A. Fuss & Vinod K. Gupta, *A Cost Function Approach to the Estimation of Minimum Efficient Scale, Returns to Scale, and Suboptimal Capacity*, 15 *EUR. ECON. REV.* 123 (1981).

19. See RICHARD E. CAVES, *DIVERSIFICATION, FOREIGN INVESTMENT, AND SCALE IN NORTH AMERICAN MANUFACTURING INDUSTRIES* 34-46 (1975).

20. See, e.g., EASTMAN & STYKOLT, *supra* note 18.

diversity, product differentiation, and the adjustment lags of constructing large plants. Yet, the most influential factor is the high level of interdependence between firms in concentrated markets. Simply put, the lower the number of firms operating in a market and the higher the barriers to entry, the greater the influence each firm will have on the market equilibrium. Firms recognize this interdependence and seek cooperative policies that are more profitable to each of them than when each firm aggressively looks for a larger market share. Accordingly, profit maximization in an oligopolistic market often requires unaggressive competitive behavior with respect to strategic decisions such as price and capacity. To be sure, interdependent behavior does not necessarily justify suboptimal production. Firms do not seek to raise their own costs when cost savings would not necessarily be passed on to consumers. The relatively large size of MES, however, may blunt incentives to adopt efficiency-enhancing measures and may lead to output levels that are suboptimal.

2.5 THE BASIC CONFLICT CREATED BY SMALLNESS

These unique economic characteristics of small economies create a basic conflict between productive efficiency and competitive conditions. If a given number of firms can operate efficiently in an industry, productive efficiency requires that the industry contain only this number of firms—all operating at efficient, productive levels.

At the same time, productive efficiency imperatives often cause industrial concentration in small economies to be high enough in many industries to allow some market power to be realized. Efficiency can be adversely affected by monopolistic market behavior patterns to which producers in highly concentrated industries are prone. The evils of monopoly have long been recognized. These include, *inter alia*, higher prices and lower output levels than under competitive conditions (allocative inefficiency), X-inefficiency, and the costs of rent seeking behavior. Under an oligopolistic structure, the actions of rivals impinge directly on each other. Consequently, firms might act interdependently. Interdependent behavior refers to explicit or implicit understandings among firms in the market to jointly exercise market power or limit competition. Such behavior has many adverse effects on productivity and resource allocation: prices are likely to be above costs; “inefficiently small competitors [may be able] to enter the market beneath the fixed-price umbrella; capacity is allowed to expand in the wrong locations or in increments that are too small [to exhaust scale economies]; . . . and various other forms of nonprice

competition that drain resources are encouraged.”²¹ Under both structures, firms also have incentives to engage in exclusionary conduct. In addition, high levels of concentration are not a free good due to the income distributions caused by increased market power and the social and political malaise that follow from excessive concentrations of economic power.

Market size also affects dynamic efficiency, which involves research and development expenditures designed to create new products and processes. On the one hand, firms in highly concentrated markets generally exhibit extremely low levels of continuous research and development. On the other, large firm size, up to a certain degree, has been proven to be positively correlated to dynamic efficiency.²²

The small size of the market thus yields a complex relationship between concentration and efficiency. Small size sharpens the dilemma between whether an economy would be better off with higher concentration to permit more efficient scales of activity or with lower concentration for better allocated efficiency through competition.

CHAPTER 3: THE IMPLICATIONS OF THE ECONOMIC CHARACTERISTICS OF SMALL ECONOMIES FOR COMPETITION POLICY

These salient characteristics of small economies have important policy implications, as they require small economies to devise appropriate endogenous policies that offset at least some of the adverse effects of small size. Since competition policy is applied to remedy certain market imperfections, it should be carefully designed to deal effectively with the unique obstacles to competition that are inherent in an economy, including those stemming from its small size. Accordingly, the empirical conclusions about the economic characteristics of small market economies should be translated into policy choices and the standard assumptions of competition policy in large jurisdictions should be adjusted to fit the special characteristics of small economies. This chapter explores the basic policy choices that need to be incorporated into the competition policies of small economies.

21. Caves, *supra* note 3, at 323.

22. See REPORT OF ROYAL COMMISSION ON CORPORATE CONCENTRATION (1978).

3.1 THE PRIMACY OF EFFICIENCY OVER SOCIAL GOALS

In a small economy, it is vital that the goals of competition policy be clearly, deliberately, and unambiguously defined, and that economic efficiency be given primacy over other goals. Goals signal to market participants, as well as to the relevant authorities, how the law should be interpreted and implemented. As will be argued in this section, while goals should always be clear, the special characteristics of small economies increase this need.

Competition policy is basically designed to protect, promote and encourage the competitive process. Competition is not an end in itself, but rather a means toward certain ends. It is valued for its effectiveness as a dynamic device for controlling the allocation of society's resources, for the enforcement of market discipline by the market pressures from alternative sources of supply, and because of the desire to keep ahead of rivals. Where competition is not effective, however, alternative measures for economic efficiency and progressiveness should be implemented. At the same time, competition may be valued for social and political reasons rather than economic ones:²³ it disperses wealth and opportunity and it limits business size.²⁴ These goals focus on distributive justice values by ensuring that no one firm alone can reap the benefits of serving the market and that all firms have an equitable opportunity to compete in it.

Small economies should, however, strive to serve only one master, economic efficiency, because they are less able than their larger counterparts to afford a competition policy that sacrifices economic efficiency for broader objectives. Where social goals conflict with economic efficiency, both goals cannot be materially promoted. Undeviating pursuit of wealth dispersion and small size of firms at the expense of efficiency will be costly in small economies, due to the fact that inefficient firms will be preserved in the market. Such protection of small firms may even harm consumers by preventing producers from realizing cost savings that come from efficient production if such cost savings would be wholly or partially transferred to consumers. If such protection were nonetheless pursued, it would have to involve the whole scope of the market since sporadic protection of small firms would make little contribution to social goals. Systematic protection, however, would impose unacceptably high economic costs on the economy and often would be futile without costly ongoing regulation due to the fact that these

23. This Paper will refer to these social and political motivations collectively as "social" goals.

24. See 1 PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* ¶ 100b. (2d ed. 2000).

inefficient firms would generally not survive in a free market and firms would have incentives to grow internally. In addition, such efforts would involve the courts or the competition agencies in essentially political decisionmaking for which there are no appropriate legal criteria, and in a costly regulatory/supervisory role for which they are ill-equipped.²⁵ Thus, the protection of competitors instead of competition in small economies appears not only to be costly, but also to produce arbitrary results that make competition law unpredictable, and to obscure clear thought about its proper and attainable objectives.

While these arguments apply to any economy, regardless of its size, smallness exacerbates the importance of the primacy of efficiency. In large economies, social values are considerably served by the competition policies that promote economic efficiency and progressiveness. Even if competition policy makes concessions to social goals, the few islands of market imperfections in a largely competitive sea are not likely to have much adverse incremental impact on the distribution of income and the maintenance of small, dispersed firms. In small economies, on the other hand, economies of scale may reduce or eliminate competition in many industries altogether. Accordingly, economic and social objectives may substantially diverge when efficiency dictates the displacement of small firms by larger business units.

Moreover, the importance of economic efficiency as a stand-alone objective is highlighted in small economies where interdependencies in the interests of various stakeholders are likely to be more significantly affected by a particular market transaction. This reality increases the probability of lobbying, rent seeking behavior, and political posturing aimed at the safeguarding or pursuing other objectives promoted by public benefit or public interest criteria. As one analyst notes, "if competition policy is influenced by non-economic considerations, the risks of costly industrial policy in the guise of competition policy becomes high."²⁶

Accordingly, in small economies social goals should be given little or no independent weight in formulating competition policy. This is not to say that where noneconomic considerations exist, such as producing a certain product within the jurisdictional borders for security reasons, they

25. *See id.* ¶ 200.

26. R. Shyam Khemani, *Merger Policy and Small Open Economies: The Case of Canada*, in *PERSPECTIVES IN INDUSTRIAL ORGANIZATION* 215, 223 (Ben Dankbaar, John Groenewegen, & Hans Schenk eds., 1990).

should not be given weight, but these considerations should be limited in their extent and clearly set out in proper legislation.

The primacy of efficiency over social goals has been recognized by some small economies. Australia and New Zealand have, for example, largely recognized the importance of stand-alone efficiency goals.²⁷

Unfortunately, most small jurisdictions are not as clear in their goal setting. The Israeli *Restrictive Business Practices Law* (“RBPL”), for example, does not include an explicit goals provision.²⁸ Several provisions signal that its ultimate goal is to regulate market conduct in accordance with the “public interest.” Public interest, however, is an elusive notion that may relate to a diversity of economic as well as noneconomic goals, which may be sometimes inconsistent. Neither the RBPL nor the legislative history are very illuminating about what specifically is allowed or prohibited. The legislative history generally does not discuss specific applications and thus seldom reveals legislative preferences on the difficult issues that need to be resolved. Generally, RBPL’s provisions do not solve possible conflicts among different goals.

Nonetheless, the rhetoric used by the courts as well as by the Director of the Competition Authority signals that the RBPL’s goal is mainly economic: to eliminate obstacles to market competition that are vital to the proper functioning of the market, and to regulate the operation and creation of economic entities that possess monopoly power.²⁹ Yet this broad rhetoric, which manipulates the competition rhetoric without penetrating the underlying substance, does not necessarily limit the possible interpretation of the legal provisions. Similarly, many small economies that have adopted EU policies or that have followed in the footsteps of the

27. Australian decisions have explicitly recognized that consumer welfare is the ultimate goal of their competition laws. See *Queensland Wire Indus. Pty Ltd. v. The Broken Hill Proprietary Co.* (1989) 83 A.L.R. 577 (Austl.). The object of the abuse of dominance provision is “to protect the interests of consumers, the operation of the section being predicated on the assumption that competition is a means to that end.” *Id.* at 585. See also *Gen. Newspapers Pty Ltd. v. Telstra Corp.* (1993) 117 A.L.R. 629 (Fed. Ct. Austl., Gen. Div.). Cf. *Union Shipping NZ Ltd. v. Port Nelson* [1990] 2 N.Z.L.R. 662 (H.C.) (illustrating application of the principle in New Zealand).

28. *Restrictive Business Practices Law 1988* (Israel). Arguably, statutory purpose clauses generally have limited effect on the application of the law in practice, as many jurisdictions adopt purpose clauses with self-contradictory goals such as the promotion of the welfare of consumers and of small producers. Clear purpose clauses can, nonetheless, limit the scope and possible interpretation of competition laws.

29. See, e.g., the decision of the Director of the Israeli Competition Authority in *Hescemein Habiladiut Bein Hevrot Hadelek Levein Mafilei Tahanot*, in [A] HEGBELIM ISKIIM 19, 38-9 (Tova Olshtein ed., 1994).

EU, implement competition policies that emphasize open borders and equal opportunity over efficiency.³⁰

It should be noted, however, that even when economic efficiency and progressiveness are the ultimate goals, they cannot be easily implemented. The complexity of setting priorities correctly in economic settings makes it difficult to create a purpose clause that will direct enforcers and market participants to a conclusive interpretation in all cases. The intermediate objectives of economic efficiency and progressiveness are comprised of allocative, productive, and dynamic efficiency. Whether particular industry practices involve acceptably competitive characteristics or unacceptable, anticompetitive ones can be evaluated in terms of their impact on these three forms of efficiency. In some settings, however, all three cannot simultaneously be realized, and where this is the case, competition policy faces complex economic tradeoffs. It is with these tradeoffs that the following sections are concerned.

3.2 RECOGNIZING THE RELATIVE IMPORTANCE OF PRODUCTIVE EFFICIENCY CONSIDERATIONS

As demonstrated above, competition policy in small economies must reconcile the technical constraints that productive efficiency places on the number of competitors with the undesirability of certain types of industry behavior created by high degrees of concentration on allocative and dynamic efficiency.

In small economies, large firm or plant size may be required in order to achieve efficient scales of production. One key implication of this fact is that high levels of concentration may be a necessary evil in order to achieve efficiency. Accordingly, competition policy in small economies should be sympathetic to the enhancement of output by individual firms, through either internal growth or mergers, which allow for the exhaustion of economies of scale that were not exhausted by previous market structures, and could not be exhausted in less anticompetitive ways.

The drawback of such a policy is that high levels of concentration might result in higher industrial concentration or absolute monopoly control. Accordingly, competition policy should strive to strike an optimal balance between structural efficiency and competitive vigor so that firms operate at efficient scales and pass at least some of the benefits of greater efficiency on to consumers. The key question involves degree, that is, how

30. For a list of economies that have adopted the competition policy of the EU, see *infra* note 82.

large are the benefits as compared to the drawbacks of a larger size of operation. The above consideration affects almost every area of competition policy. This is well illustrated in two areas: policies toward horizontal mergers and policies directed toward cooperative agreements among potential rivals.

A. Horizontal Merger Review

Merger policy best illustrates the importance of productive efficiency considerations in small economies. By definition, a horizontal merger reduces the number of competitors in the market, and the resulting entity ordinarily has a larger market share than either of the merging parties had before the merger. This reduction in the number of firms, and increase in market share, may substantially lessen competition by increasing the market power of the combined entity or by facilitating interdependent behavior among firms. At the same time, a merger may enhance efficiency by allowing firms to attain scale economies that were unattainable under the premerger market structure—either because of firm interdependence or the absolute size of firms. The benefits of reduced costs may even be passed on to consumers if the cost advantage is great enough that the new price is lower than the premerger price.

Large economies tend to use structural variables as the main guide in determining the likely competitive consequences of mergers. The dilemma between increased efficiency from the realization of scale economies, on the one hand, and the increase in market power and its accompanying reduction in competition, on the other, is nonexistent in most industries in a large economy. Thus, many large economies adopted a common approach that signifies the absolute value of competition over increased total efficiency. The underlying assumption was that there was no need for high concentration levels to achieve efficiency. Such an assumption holds true in most industries in large economies, as they tend to have a large number of firms that can operate efficiently. Moreover, an erroneous assessment of the economic effects of a merger is likely to have a relatively small impact on a large economy compared to a smaller one.³¹

Take, for example, the U.S. approach toward horizontal mergers that was prominent until the 1970s. Merger policy was based on rigid structural assumptions implying that high degrees of concentration were harmful to the economy and thus should be prohibited, even if they entailed improved

31. See Khemani, *supra* note 26, at 223.

efficiency.³² The dominant approach stressed the absolute value of competition as a regulatory tool. In a famous quote from *Philadelphia National Bank*, the Supreme Court stated that a merger producing an anticompetitive effect “is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial.”³³ Accordingly, a merger was categorically prohibited if it lessened competition substantially. Efficiency entered into the debate only in determining the scope of the antitrust rules. Based on the presumption that higher concentration creates negative effects on competition, agencies and courts developed unitary market share rules for prima facie illegality.³⁴

Such a policy would necessarily have detrimental results for small economies, in which concentration is a necessary evil in order to realize scale economies. Therefore, prohibiting all mergers that increase concentration above relatively low thresholds would be economically harmful. An overly aggressive or rigid stance toward mergers may prevent desirable efficiency-enhancing mergers from taking place. A small economy should, instead, adopt a merger policy that is more accommodating of efficiency defenses, and that relies less on structural variables alone or on rigid and limiting structural assumptions.³⁵

An overly permissive policy may, however, entrench monopoly elements in a market. The relative economic consequences of this adverse outcome will tend to be greater in small economies than in larger ones, given high entry barriers. Moreover, merger policy is the most powerful weapon available in the competition policy arsenal to combat tacit collusion or cooperative behavior. Generally, since such conduct cannot be directly reached, one should try to prevent the creation of market structures that tend to facilitate collusion-like outcomes. Merger policy should thus

32. Hovenkamp goes further to suggest that mergers were prohibited *because* they might improve efficiency and thus create higher entry barriers into their markets. See HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY 499–500 (2d ed. 1999). The Supreme Court has rejected the relevancy of efficiency in horizontal mergers. See, e.g., *Ford Motor Co. v. United States*, 405 U.S. 562 (1972); *FTC v. Proctor & Gamble Co.*, 386 U.S. 568, 580 (1967) (“[p]ossible economies cannot be used as a defense to illegality”); *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321 (1963); *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962).

33. *Philadelphia Nat’l Bank*, 374 U.S. at 371.

34. See HOVENKAMP, *supra* note 32, at 500.

35. See Khemani, *supra* note 26, at 223. The Canadian *Competition Act* prohibits the Competition Tribunal from finding that a merger is anticompetitive “solely on the basis of evidence of concentration or market shares.” *Competition Act*, R.S.C., ch. C-34, § 92(2) (1985) (Can.).

consist of a set of flexible instruments to be applied on a case by case basis to mitigate competition concerns while promoting economic efficiency.³⁶

The main policy vehicle for achieving this goal is the adoption of an approach that balances the potential procompetitive and anticompetitive effects of a proposed merger. Given that efficiencies vary widely from one industry to another, such that no general presumptions can be made based on market structure alone, this requires a case by case or industry-specific analysis of the potential efficiencies in each specific market setting. The adopted rules should enable the merging parties to prove their claim of efficiencies realistically, where such efficiencies exist. This requires that legal presumptions, burdens of proof, and the balancing rule be specified reasonably. The need for sensible rules can be illustrated by contrasting the Canadian and the current U.S. approach toward mergers, both of which adopt, at least in theory, a balancing rule.

The U.S. merger policy has changed significantly since the 1970s, recognizing the benefits that can accrue from certain mergers in some market settings, even if they bring about high levels of concentration. This approach is most apparent in the 1992 Horizontal Merger Enforcement Guidelines (Guidelines) published jointly by the Department of Justice and the Federal Trade Commission, and modified in 1997.³⁷ The Guidelines use several nonconcentration factors as mitigating or aggravating circumstances in addition to purely structural measures. Most importantly, they allow an efficiency defense as long as the merging parties can show that the proposed merger's efficiency benefits to consumers will outweigh the negative impact of increased concentration on consumer welfare. The basic rules, especially the legal presumptions and burdens of proof, however, still convey an underlying assumption against concentration. Although there is more sensitivity toward gains from production and distribution economies, the efficiency defense is very limited and hard to prove.³⁸ Most courts require that in addition to sufficiency and necessity, efficiencies must be passed on to consumers. The Guidelines clearly state that efficiencies almost never justify a merger to monopoly or near-

36. See Khemani, *supra* note 26, at 226. See also OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 249 (1975).

37. Merger Guidelines, 4 Trade Reg. Rep. (CCH) (Apr. 17, 1997) ¶ 13,104. Although the Guidelines do not legally bind the courts, their importance stems from the fact they guide the competition authorities and that, in practice, most mergers are not contested in court.

38. See, e.g., Joseph F. Brodley, *Proof of Efficiencies in Mergers and Joint Ventures* 64 ANTITRUST L.J. 575 (1996); Michael L. Weiner, *Antitrust and Enhancing Efficiency* 11 ANTITRUST 4 (1997).

monopoly.³⁹ To date, no U.S. merger, in any industry, has been affirmed based on offsetting efficiencies.⁴⁰

The Guideline's approach is not well suited to deal with concentrated market structures justified by scale economies. This is exemplified by the U.S. treatment of mergers in the health care industry.⁴¹ Because the markets are regionalized, the U.S. health care industry suffers from many of the problems faced by markets in small economies. Therefore, scale economies in the health care industry are large relative to market size, and interdependent conduct is widespread. In determining the legality of horizontal mergers in this industry, U.S. courts have exhibited little sensitivity to the unique characteristics of the market. Even when courts recognize efficiency defenses and smallness, the analysis resembles that of a large market: Similar concentration ratios are used for presuming anticompetitive effects, and efficiency claims meet with the same skepticism as such claims do in large markets.⁴² Similarly, the DOJ and FTC Health Care Industry Guidelines, while acknowledging the issues of a small health care market, have adopted low concentration thresholds and count on a highly conditional efficiency defense to address the special characteristics of the market.⁴³ Since it is quite common that concentration ratios are high in the health care industry, challengers of a merger are often able to establish a prima facie presumption of anticompetitive effects. Hence, analysis of anticompetitive effects almost always produces strong inclinations toward the condemnation of a merger. This factor, disfavoring merger, combined with the often insurmountable burden of an efficiency

39. See Merger Guidelines, 4 Trade Reg. Rep. (CCH) (Apr. 17, 1997) ¶ 13,104.

40. The only decision that came close was the recent decision of the district court that declined to issue a temporary injunction against a proposed merger, based on efficiency considerations. *FTC v. H.J. Heinz, Co.*, 116 F. Supp. 190, 198–99 (D.D.C. 2000). The decision was overturned by the Court of Appeals. *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 711 (D.C. Cir. 2001).

41. See Gilo, *supra* note 6, at 165.

42. See *FTC v. University Health, Inc.*, 938 F.2d 1206, 1222–23 (11th Cir. 1991) (surprisingly concluding that the requirement of proof must be strict due to the greater possibility of the existence of unattainable economies); *United States v. Rockford Memorial Corp.*, 717 F. Supp. 1251, 1287–91 (N.D. Ill. 1989) *aff'd* 898 F.2d 1278 (7th Cir. 1990) (examining concentration ratios as in a large market analysis). “[C]ompetition is likely to be greatest when there are many sellers, none of which has any significant market share.” *Id.* (quoting *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321, 363 (1963) (quoting Comment, “*Substantially to Lessen Competition . . .*”: *Current Problems of Horizontal Mergers*, 68 *YALE L.J.* 1627, 1638–39 (1959))). This is a typical large market analysis that presumes that scale economies pose no problem. *But see United States v. Carilion Health Systems*, 707 F.Supp. 840 (W.D. Va., 1989) (considering adoption of efficiency claims where defendants are nonprofit entities claiming savings will be passed on to consumers, but basing decision on competition from outpatient clinics).

43. See Statement of Policy in Health Care Industry, *supra* note 8.

defense, causes the problems of scale economies in the health care industry to be systematically undertreated.⁴⁴

In Canada, on the other hand, there is no general prohibition against mergers that tend to enhance market power or even create a monopoly.⁴⁵ Canadian competition legislation is unique in providing for an explicit efficiency exception to otherwise anticompetitive mergers. When a merger is expected to be both anticompetitive and efficiency enhancing, the *Competition Act* resolves the conflict in favor of the merger when the likely efficiency gains are greater than, and offset, the likely anticompetitive effects, and efficiency gains would not be attained if the merger was prohibited.⁴⁶

Yet in the recent *Superior Propane* decision,⁴⁷ the Canadian Federal Court of Appeal limited the weight to be given to efficiency considerations. The Court replaced the total welfare standard that was applied for many years by the Canadian Antitrust Bureau in merger cases, with a more flexible but amorphous balancing weights approach.⁴⁸ Under the new standard, the antitrust authority must balance between economic efficiency and social goals, such as distributive effects and loss of product choice, but none of these factors would be assigned a fixed, *a priori* weight. This test significantly increases the discretion of the antitrust authority to evaluate a merger on non-economic grounds.

Many small economies adopt a policy that is more accommodating to efficiency considerations than those adopted by large economies. Table 2, which surveys the requirements for cognizable efficiencies adopted by different jurisdictions, clearly indicates that the size of a jurisdiction is positively correlated to the requirements for cognizable efficiencies. Small economies, which have a stronger incentive to attempt to strike the optimal balance between the merger's benefits and detriments, are willing to exercise more leniency toward efficiency claims.

44. See Gilo, *supra* note 6, at 179–81.

45. Of the 260 mergers that have been reported to the Canadian Competition Bureau during the period between 1988–94 only four have been rejected and a few others required minor changes.

46. See *Competition Act*, R.S.C., ch. C-34, § 96(1) (1985) (Can.).

47. *Comm'r of Competition v. Superior Propane Inc. and ICG Propane Inc.*, Apr. 4, 2001 (Fed. Ct. App.) (Can.) (unpublished decision on file with author).

48. It should be noted that the Canadian Competition Bureau advocated the adoption of the balancing weights test. This position departed from the Bureau's own *Merger Enforcement Guidelines*, which set out a total surplus standard.

REQUIREMENT	JURISDICTION*			
	U.S.A.	Canada	Australia	New Zealand
Burden of Persuasion	Merging parties	Merging parties	Merging parties	Merging parties
Standard of Proof	"Clear and convincing" (Guidelines)	Balance of probabilities	"Probable effect"	Tendency or real probability
Consumer Welfare Standard?	Yes	No, Balancing weights test	No, Total welfare	No, Total welfare
Real savings?	Yes	Yes	Yes	Yes
Necessity?	Yes	Yes	No	
Achievable in the Relevant Market?	Yes	No	Unclear	Unclear

Table 2: Requirements for cognizable efficiencies adopted by different jurisdictions

* Jurisdictions are organized in order of size

One example involves the balancing formula. A consumer welfare standard imposes a greater burden on the merging parties than a total welfare standard. The consumer welfare standard will only be met if, in the postmerger situation, the price will not increase beyond the premerger price, because the new efficiencies are so significant as to cause the profit maximizing price not to rise above the premerger price. Under the total welfare approach, a merger is permitted if it increases total surplus, which includes both consumer and producer surplus, notwithstanding an increase in prices above premerger levels. Many small economies have opted for the lower total welfare standard, while large ones adopt the consumer welfare standard. A similar tendency can be detected with regard to other requirements for cognizable efficiencies.

B. Cooperative Agreements Among Rivals

The small size of an economy also exacerbates some of the issues involved in the regulation of cooperative agreements among rivals, such as specialization agreements or joint ventures and strategic alliances for shared research and development, production, or marketing functions. Such agreements raise trade restraint concerns, especially the facilitation or enhancement of cooperation among competitors in an already concentrated

market.⁴⁹ At the same time, cooperative agreements may enable a group of firms to carry on an activity on a more efficient scale; to reduce information or transaction costs; to engage in expensive innovative projects; or to eliminate free rider problems. Absent such agreements, many firms in small economies must incur high costs because they cannot reach scale economies on their own. Firms that cannot sustain these costs must abandon these projects altogether, thereby reducing dynamic, productive, and even allocative efficiency.⁵⁰

Accordingly, small economies should reject a policy that views agreements that have the potential to increase productive or dynamic efficiency as illegal per se.⁵¹ Such per se rules may create inefficiencies in small economies, given that cooperative agreements may be the only way for market participants to achieve minimum efficient scales and to lower costs to levels that any single firm acting alone could not achieve under the existing market structure. Rather, small economies should opt for a rule that balances possible efficiency enhancements against anticompetitive effects of the cooperative conduct, and allow arrangements in which the benefits offset the restrictions on competition.

Australia and New Zealand have recognized the importance of a rule of reason analysis of cooperative agreements for the ability of small businesses to compete with larger ones.⁵² Both jurisdictions exempt joint buying and selling activities from per se illegality as price fixing if the price-fixing agreement relates to the price for goods or services to be acquired collectively by the parties or the joint advertising of the price for the sale of goods or services collectively acquired. These jurisdictions have recognized that such agreements enable smaller entities to compete effectively with larger ones.

The Australian attitude toward buying groups is reflected in the Trade Practices Commission's *Pharma-Buy* decision.⁵³ The Commission granted

49. See, e.g., *N. Natural Gas Co. v. Fed. Power Comm'n*, 399 F.2d 953, 972 (D.C. Cir. 1968); *Energiyat Hamizrach Hatichon*, May 13, 1997 (unpublished decision on file with author).

50. See Poligar, in [A] HEBELIM ISKIIM, *supra* note 29, at 108. See also Australian's Comalco Aluminum Joint Venture Application, A90265, Aug. 21, 1979.

51. Such a rule was adopted in the U.S. with regard to agreements for territorial division. See *U.S. v. Topco Ass'n.*, 405 U.S. 596, 607–08 (1972). Similarly, in the EC the efficiency defense for cooperative agreements was interpreted as not applying where it eliminates effective competition. CHRISTOPHER W. BELLAMY & GRAHAM CHILD, *COMMON MARKET LAW OF COMPETITION* 165–66 (Vivien Rose ed., 4th ed. 1993).

52. Commerce Act § 33, 1986 (N.Z.); Trade Practices Act, 1974, c. 45(1)–(3) (Austl.).

53. *E. F. Found Pty Ltd. & William Hodge Pty Ltd.*, C4272, July 11, 1975. See also *E. Express Pty. v. Gen. Newspapers Pty.* [1992] 106 A.L.R. 297 (enabling small grocers to increase their buying power toward the level that their competitors exercised).

clearance to a buying and promotion scheme involving forty pharmacists in Melbourne. The group comprised a small portion of the relevant market, and outlets were geographically spread. The Commission stated, “the effect of the promotion is to enable this small group of outlets to compete more effectively against other more substantial outlets in the market.”⁵⁴

This decision can be contrasted with the U.S. *Topco* case. *Topco* involved a cooperative association of small and medium-sized retailers that desired to obtain high quality merchandise under private labels in order to compete more effectively with larger national and regional chains.⁵⁵ The association required exclusivity through trademark licenses specifying the territory in which each member could sell such trademarked goods.⁵⁶ The District Court applied a rule of reason analysis and found that such restrictions were required to allow small retailers to compete effectively with larger ones.⁵⁷ The Supreme Court reversed, applying a per se rule of territorial restraints and prohibited the conduct.⁵⁸

Application of the *Topco* per se rule to territorial restraints in small economies could be harmful, as small competitors would be prohibited from using certain competitive methods, which could outweigh potential anticompetitive results, in order to challenge dominant firms that are much more prevalent in small economies.

3.3 THE EFFECT OF SMALL SIZE ON LEGAL PRESUMPTIONS

Another important characteristic of small economies is that they cannot afford to transplant simplistic rules of thumb, market thresholds, or legal presumptions that are applied in larger markets because these are based on different market conditions.

A. Market Share As an Indicator of Market Power

An interesting example of a rule of thumb that does not apply equally to large and small economies is the use of a predetermined market share threshold in deciding whether or not a firm possesses market power. Although market share indicators are not an accurate method of appraising

54. E. F. Found Pty Ltd. & William Hodge Pty Ltd., C4272, July 11, 1975.

55. See *United States v. Topco Ass'n* 405 U.S. 596, 607–08. Several lower courts have nonetheless applied a rule of reason when horizontal market division was found to be ancillary to a joint venture. See, e.g., *Gen. Leaseways, Inc. v. Nat'l Truck Leasing Ass'n*, 744 F.2d 588 (7th Cir. 1984).

56. *Topco*, 405 U.S. at 601–03.

57. *Id.* at 606–07.

58. *Id.* at 607–11.

market power, many courts worldwide rely on long-standing market share as a primary indicator of market power and interpret this data in each case by reference to the qualitative indicia of the market's elasticity of demand and supply. Where it can be shown that the assumption is false, appropriate adjustments are made.⁵⁹

Market share triggering figures are important since demand and supply elasticities, which are the basis of more accurate market power indicators, are not easily determinable, while information of the firm's market share will normally be available and reasonably accurate. Market share statistics also create administrative convenience and they signal to market participants, although without precision, which particular market share thresholds create safe harbors. While the market-share based approach to market power has encountered much criticism, it is commonly used in most, if not all, jurisdictions.⁶⁰

In small economies the *typical* market share threshold that will signify market dominance should be lower than in larger ones because elasticity of supply will usually be lower, given the prevalence of scale economies and oligopolistic interdependence. When the market is small, barriers to entry are usually higher. Therefore, potential entry places fewer constraints upon a firm that attempts to raise price above marginal cost, and a lower market share necessary in order to infer dominant market power. For example, where large scale economies exist, the dominant firm may be the only one able to enjoy low production costs, while fringe firms compete with higher production cost products under the price umbrella of the dominant firm or compete with highly differentiated products.⁶¹ Also, firms operating in a market with high entry barriers acknowledge their interdependence and are more prone to follow the price leadership of a dominant firm or act

59. William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 946-47 (1981).

60. See, e.g., Jonathan B. Baker & Timothy F. Bresnahan, *Estimating the Residual Demand Curve Facing a Single Firm*, 6 INT'L J. INDUS. ORG. 283 (1988); Louis Kaplow, *The Accuracy of Traditional Market Power Analysis and a Direct Adjustment Alternative*, 95 HARV. L. REV. 1817 (1982); Richard Schmalensee, *Another Look at Market Power*, 95 HARV. L. REV. 1789 (1982).

61. This argument can be proven by using algebraic formulae. The Lerner index which indicates the proportional derivation of price at the firm's profit maximizing output from the firm's marginal cost at that output can be calculated by using three factors: market demand elasticity, supply elasticity of competing or fringe firms and the relevant firm's market share. The market power of a firm can be computed as follows: $Li = Si / (Edm + Esj(1 - Si))$ where "Li" is the Lerner index of firm i, "Si" is the market share of firm i, "Edm" is the market elasticity of demand, and "Esj" is the elasticity of supply of competing or fringe firms. Using the Lerner index formula, it is simple to see that when we hold Li (the degree of market power) and Edm constant and we vary Esj. When Esj is high, we need a lower Si to offset its effect. It should be noted that the Lerner index is based on assumptions of Cournot competition.

interdependently. Thus, in small economies, a given market share will usually signify more market power than in large ones. This is true, however, only as a general presumption, in light of the possibility of adjustments where other factors, such as the elasticity of demand or supply, differ significantly from the typical case.

As Table 3 indicates, not all competition laws of small economies seem to take these differences into account. While the Australian legislature has recently lowered the threshold for dominance and the Israeli law treats a market share of 50% as sufficient to establish market power, New Zealand has adopted a rigid and rigorous test for dominance, and Cyprus adopts the thresholds of the EU.

JURISDICTION*	DOMINANT POSITION DEFINITION	MARKET POWER THRESHOLD	THRESHOLD: MANDATORY OR SUGGESTIVE
U.S.A.	Monopoly Power	Usually 70–75%; rarely below 50%	Suggestive
EU	Dominant position	40–60%	Suggestive
Britain	Monopoly	25%	Mandatory but much flexibility in process
Canada	Substantial control	87% high enough; predatory pricing guidelines 35%	Suggestive
Australia	Significant market power	60% large enough; 7–15% too low	Suggestive
New Zealand	Dominant position	Higher than in Australia and the EU	Suggestive
Israel	Significant influence on market	50%	Mandatory unless Minister declares lower
Malta	Dominant position	40%	Mandatory unless proven to be lower
Cyprus	Dominant position	Follow the EU	Suggestive

Table 3: Market power thresholds in different jurisdictions

* Jurisdictions are listed in order of size

B. Structural Presumptions of Anticompetitive Effects

The legal presumptions regarding the effects of a merger adopted in the U.S. also illustrate the importance of fine-tuning such presumptions to

economic size. The U.S. Horizontal Merger Guidelines⁶² employ the Herfindahl-Hirschman Index (“HHI”), which indicates the level of concentration in the market based on both the number of firms operating in the market and on their relative market shares.⁶³ Although the HHI is only a prima facie indicator of the anticompetitive effects of a merger, its thresholds are important for setting merger review standards since they create a presumption of illegality. The Guidelines define highly concentrated markets as those in which the postmerger HHI is 1,800 or more. Where merger increases the HHI by more than 100 points, it is presumed that the transaction is likely to create or enhance market power or facilitate its exercise. This choice of index is based on generalized predictions of gains from size as well as behavioral assumptions about the market. As the chosen HHI threshold (1800) is met with the market shares of five equal firms, it is presumed that, absent clear showings to the contrary, firms in such markets already have exhausted scale and scope economies. Thus, the cost savings from the merger will be very low.

The small size of a market and the resulting need to enable firms to grow to relatively large sizes in order to realize scale economies require the rejection of the U.S. concentration test in small economies and the adoption of a higher threshold. Adoption of the U.S. HHI levels will result, for example, in a presumption of illegality in a merger between the two smaller firms in a market with six businesses—four holding approximately 20% market shares and two holding approximately 10% each. Objection to such mergers will not comport with the special economic conditions of a small market, as it is not uncommon for firms that have not reached the MES to possess such a market share. Accordingly, many, if not most, proposed mergers would cross this threshold, although they will not always enhance or create market power or facilitate its exercise. Consequently, many firms would be prevented from realizing scale economies.⁶⁴

62. See Merger Guidelines, *supra* note 37.

63. “The HHI is calculated by summing the squares of the individual market shares of all the participants.” *Id.* For example, a market with two equally sized firms, each with a 50% market share, would have an HHI of 5000 ($50^2 + 50^2 = 5000$).

64. All small economies surveyed allowed much higher concentration levels. Regarding Canada, for example, see *Director of Investigation and Research v. Hillsdown Holdings (Canada) Ltd.* [1992] 41 C.P.R. 3d 289; 1992 C.P.R. Lexis 1698 (holding the merger of two rendering operations did not “substantially lessen competition” despite a change in the HHI from 1594 to 3608 and the merging parties having more than 56% of the postmerger productive capacity to render red meat material). New Zealand and Australia have adopted “safe harbors” for mergers that set a high concentration threshold. For the Israeli court’s rejection of the U.S. HHI levels see Appeal 2/94 Tnuva Mercaz Shitufi Leshivuk Neged Hamemune Al Hahegbelim Haiskiim, *in* [B] HEGBELIM ISKIIM, *supra* note 29, at 159. See also Efraim Zdaka, Asaf Razin, Yaakov Sheinin, & Menachem Perlman, *Monopolim Vemizugim Bitnaei*

C. Prohibitions of Price and Nonprice Discrimination

In regulating discriminatory policies adopted by a dominant firm, small economies may need to apply a different set of rules in order to achieve the goals of competition policy. Price and nonprice discrimination, whereby a monopolistic supplier charges two or more customers different prices or applies different trade terms that have no direct relation to the costs of supplying these customers, is categorically prohibited in most economies.⁶⁵ One of the main objections to price discrimination is that it may be used to punish an oligopolist that “acted out of line.” To the extent that discrimination suppresses rivalry in particular segments of the discriminating firm’s market, it may have negative dynamic effects on the state of competition in that market by retarding the normal downward slippage of oligopolistic prices.

In oligopolistic markets, discriminatory pricing or trade terms may, however, be part of proconsumer market scenarios in which previously stable oligopolistic price structures are ultimately shaken loose and lowered to the benefit of the public. Oligopolists often do not compete directly on price, but rather compete in other ways, principally through secret loyalty rebates and discounts that frequently discriminate among individual customers. Such discounts are generally to be encouraged. To forbid them would often reduce efficiency and slow reactions to changed market conduct.

This suggests that if discrimination prohibitions apply to firms operating in oligopolistic markets, then caution should be exercised in order to distinguish between scenarios where discrimination is a means for the breakdown of oligopolistic price coordination, and other scenarios wherein certain sellers succeed in using discrimination as a means of disciplining rivals, and market prices are ultimately maintained or pushed higher. An overly strict approach to discrimination whereby all such practices are condemned as abusive might actually enhance oligopolistic behavior as the little remaining competition is inhibited. Discrimination in small economies, thus, merits a deeper analysis of its real effects on the market. The downside of such a policy is that detailed prescriptions might demand case specific microeconomic analysis. Nonetheless, several rules

Hasifa, RIV’ON LECALCALA. 53 (1992) (recommending the adoption of an HHI index threshold of 5000 in Israel).

65. See, e.g., Competition Act, R.S.C., ch. C-34, § 34 (1985) (Can.); Restrictive Business Practices Law, § 29(B)(3), 1988 (Israel); Treaty of Rome (1957), as amended by Treaty Establishing the European Community, Feb. 7, 1992, art. 86, 1992 O.J. C224.; Competition Act No. XXXI § 9, 1994 (Malta).

of thumb may assist competition authorities and courts in determining the legality of discriminatory conduct. Three main factors can signal that a more cautious analysis needs to be performed before the effects of the discriminatory conduct are determined: (1) the market is oligopolistic in nature; (2) potential competitors adopt parallel pricing policies; and (3) discrimination is secret, in order to hide it from rival oligopolists.

3.4 THE LIMITED EFFECTIVENESS OF STRUCTURAL REMEDIES

Another implication of the unique characteristics of small economies is that structural remedies to lower seller concentration are limited where scale economies are significant. Structural remedies, such as the dissolution of monopolistic or oligopolistic structures by reducing concentration, may help reduce the feasibility of market power, collusion, and interdependent behavior. Such structural measures, however, even if they can be effectively implemented, usually imply a tradeoff between enhancing competition and exploiting potential cost efficiencies that flow from minimum efficient scales of production when applied in small economies. Even if firms can be broken up into smaller parts, market demand might constrain the number of efficient units so that oligopolistic conditions would prevail. In addition, structural remedies may not be effective without costly ongoing regulation, due to the fact that small inefficient firms would not survive in a free market and would never grow to larger sizes that allow them to take advantage of scale economies. An important implication of the preceding discussion is the benefit a small economy may derive from the rejection of laws prohibiting large size per se, such as those suggested in several large economies.⁶⁶

Nevertheless, where structural remedies may achieve efficient results in small economies, they should be seriously considered. Given the many problems involved in conduct regulation, structural measures may provide an important solution. One example involves cross-holdings between dominant conglomerates. High levels of aggregate concentration and interdependence between large market players are characteristic of small economies. Consequently, cross-holdings or joint ventures that may reduce future competition between these large players should be analyzed in a broader perspective, taking into account the long-term dampening of

66. See, e.g., United States Concentrated Industries Act, S. 2614 92nd Cong. (1971); Senator Hart's Industrial Reorganization Act: S. 1167 93rd Cong. (1973) reintroduced as S. 1959, 94th Cong. (1975).

competition among such conglomerates.⁶⁷ This holds true even if the specific arrangement otherwise enhances efficiency. Such ventures should be prohibited when there is an overall negative effect on the level of competition in all markets affected. Unfortunately, not all small economies recognize this need.⁶⁸

The concentrated nature of a market also raises an additional structural consideration that is generally absent in large economies. A court in a small economy should take into account the effect of its remedy on the current market equilibrium when attempting to restore competition in a market.⁶⁹ If the court goes beyond what is necessary in order to restore competition in the market and to eradicate the consequences of the anticompetitive conduct, it might create a situation that is counterproductive to competition.

Four conditions have to be met for this to happen. First, the market can support only a small number of firms. Second, entry barriers are high. Third, the judicial remedy creates such a comparative disadvantage to a competitor that it must exit the market. Fourth, the exiting firm's assets are not utilized by a new firm, such as a successor in bankruptcy. Put differently, although competition policy is designed to protect competition and not competitors, in some markets it might be important to exercise caution with regard to the viability of competitors, if their viability is crucial for competition.

Take, for example, a market situation in which the relevant market can support only three firms, the number of competitors that actually exist in the market. Assume that one firm is found to engage in anticompetitive behavior and that the court does not exercise enough caution in its decision such that the firm has to exit the market due to a significant comparative disadvantage created by the court's decision. If a new entrant faces high barriers to entry, this change in market structure may affect the pricing behavior of firms in the market, given that the remaining duopoly is more likely to engage in price-fixing or price coordination. The exit of a competitor from the market also may be of great economic impact where the market can or may support only one firm, and several firms engage in competition for the market. Efficiency dictates that the most efficient

67. See, e.g., *Ishur Mizug Bitnaim Lefi Saif 21 Lehok Hahegbelim Haiskiim* 1988: Columbus Capital Corp. *Mikvutzat Klaridge Ve Cur Taasiot Baam*, Jan. 5, 1988 (on file with author).

68. E.g., Canadian Director of Investigation and Research, *Merger Enforcement Guidelines*, 1991.

69. See Michal S. Gal, *Harmful Remedies: Optimal Reformation of Anti-Competitive Contracts*, 22 *CARDOZO L. REV.* 91 (2000) (providing an extended analysis of this consideration).

competitor serve the market. Yet if a superior potential competitor engages in anticompetitive conduct while competing for the market and the court hearing the case creates a great comparative disadvantage for this firm, the firm might exit the market. Consequently, efficiency will not be achieved.

This can be illustrated by the Canadian *Nielsen* case.⁷⁰ There, Nielsen, the only firm operating in the market, was found to engage in anticompetitive exclusive dealing contracts with its suppliers and customers, which served to create artificial barriers to the entry of its potential competitors.⁷¹ The Canadian Competition Tribunal struck down the exclusivity clauses in Nielsen's existing contracts, without interfering with the rest of the contractual terms.⁷² The Tribunal acknowledged that striking down the exclusivity clauses in Nielsen's contracts with its suppliers without addressing the current payment clauses, which were of a blended nature (i.e., they contained a single payment for the data and exclusive access to it), might be problematic.⁷³ The problem was that "Nielsen might have to continue its current level of payments, without receiving the benefits of exclusivity the payments were intended to secure, while its [potential] competitor makes payments at a lower level."⁷⁴ The Tribunal chose to sidestep this issue, however, by refusing to comment on whether or not this was a valid concern for it to address.⁷⁵ This remedy could have required Nielsen to suffer great losses and exit the market. Fortunately, Nielsen's incentives for exclusivity were aligned with those of its suppliers, who shared some of the profits from Nielsen's position as a sole service provider and continued to grant Nielsen de facto exclusivity even after the court remedy.⁷⁶

3.5 THE IMPORTANT ROLE OF CONDUCT REGULATION

The adoption of a more lenient policy toward mergers and the internal growth of firms must be accompanied by legal rules minimizing the effect of more concentrated market structures on industry efficiency. Competition policy in a small economy should, thus, pursue a behavioral policy that applies strict rules toward manifestations of market power that

70. Dir. of Investigation & Research v. D&B Cos. of Canada Ltd., [1996] 64 C.P.R.3d 216.

71. *Id.* at 267.

72. *Id.* at 282.

73. *Id.*

74. *Id.*

75. *Id.*

76. See Michal S. Gal, *The Nielsen Case: Was Competition Restored?*, 29 CAN. BUS. L.J. 17 (1997).

are clearly anticompetitive and supports the dynamic, long-run market forces leading to more efficient market structures.

A. Strict Anticollusion and Anti-Exclusionary Policy

One of the methods to achieve such a goal is to adopt a strict anticollusion and anti-exclusionary conduct policy. The limited number of firms that can operate in a small market necessarily increases interdependent conduct. The number of firms in most industries is so small that even in the absence of restrictive agreements there is little room for effective domestic competition. Conscious parallelism is normally all that is needed in order to facilitate interdependent conduct. Outlawing such conduct is problematic because, *inter alia*, it is almost impossible for a market regulator to prescribe a different pattern of behavior that can be enforced easily.⁷⁷

Yet, where such collusive conduct becomes tacit collusion, a strict anticollusive policy should be applied. Such a policy may help break down oligopolistic coordination and induce oligopolists to operate at higher levels of output and lower prices than they would have in the absence of legal consequences. This, in turn, will enhance allocative efficiency. Thus, the policy toward illegal cartels should be very strict in small economies.

Similarly, a strict policy should be adopted toward exclusionary practices with no offsetting benefits, when practiced by dominant firms. Such a policy should particularly focus on deterring the creation and maintenance of artificial barriers to entry, in order to permit new firms to enter and to expand in oligopolistic or monopolistic industries and increase competition. New entrants must have the opportunity to enter a market without handicaps other than those arising from the fact that existing competitors have first mover advantages, such as well-established ties with consumers and skilled employees. Predatory pricing, for example, whereby a firm lowers its prices with a view of raising them once its competitor(s) exit the market, should be strictly prohibited.

77. Some commentators have suggested placing legal restrictions on conscious parallelism in small economies. *See, e.g.*, Bernadett Muskat, Regulation of Parallel Behavior in an Oligopolistic Market: Myth or Reality? (paper presented at the International Conference on Competition & Competition Law in Small Jurisdictions, Malta, May 21–23, 1998). The Spanish Act prohibits “knowingly parallel activities, whose object or whose effect is to prevent, to limit, or to distort competition.” Act Against Restraints of Competition (B.O.E. 1989, 16). “Se prohíbe todo acuerdo, decisión o recomendación colectiva, or práctica concertada o conscientemente paralela, que tenga por objeto, produzca o pueda producir el efecto de impedir, restringir, o falsear la competencia . . .” *Id.* Tit. I, ch. 1, art. 1(1). Such suggestions are problematic both from a practical and a theoretical point of view.

B. Regulation of Monopolies Per Se

Small size also sharpens the dilemma of whether or not monopolies should be regulated without requiring proof of anticompetitive intent or conduct. Regulation of mere monopoly suffers from severe drawbacks in small and large economies alike. Apart from distorting the incentives of firms to innovate and to compete vigorously in the market in order to become monopolists, remedies are problematic. Yet, market size influences the comparative weight of some of the considerations that determine whether to regulate mere monopoly. First, the market's self-correcting tendencies are more pronounced in large economies than in smaller ones. In large economies, such tendencies are believed to deal effectively with most nonnatural monopolies.⁷⁸ This, however, cannot as easily be said of small economies. In small economies, market conditions are such that the self-correcting forces of the market have a far more limited effect, and thus, the market cannot as easily be relied upon to erode a dominant position. Second, the effects of single firm dominance on a small economy might be more pronounced than on a large one. Certainly, a large economy may suffer a larger economic impact from dominance than would a smaller one, in absolute terms. The prevalence of dominance in a larger number of industries in small economies, however, may create a far more significant proportional impact.

These considerations imply that a small economy requires a more serious analysis of proposals to regulate monopolies per se. Such issues cannot be brushed aside under the assumption that market forces will take their course in due time. Monopoly provisions will have limited efficacy in small markets if based on the assumption that once abuse of monopoly power is prevented the markets will operate efficiently without regulation. Regulatory intervention might, in fact, be required if monopoly costs are to be reduced.

These factors have tipped the scale in many small economies in favor of regulating monopoly, as illustrated by Table 4. Many small economies

78. See, e.g., *Standard Oil Co. v. United States*, 221 U.S. 1, 62 (1911); *United States v. Am. Can Co.*, 230 F. 859, 902 (D. Md. 1916) (speculating that "[p]erhaps the framers of the Anti-Trust Act believed that, if such illegitimate attempts were effectively prevented, the occasions on which it would become necessary to deal with size and power otherwise brought about would be so few and so long postponed that it might never be necessary to deal with them at all"). See also Oliver E. Williamson, *Dominant Firms and the Monopoly Problem: Market Failure Considerations*, 85 HARV. L. REV. 1512, 1513-14 (1972). The conduct approach is based on the belief that "competition works—at least in the limited sense that, absent deliberate impairment of competition, actual and potential business competitors can be relied upon to perform self-policing functions by responding appropriately to opportunities for private gain." *Id.*

address the monopoly problem by subjecting monopolies to conduct regulation, which is not based on anticompetitive conduct or intent, but rather focuses solely on high prices, restricted output, or other specified trading conditions. In so doing, the law creates safeguards from monopolistic activity, while not condemning monopoly per se. The efficacy of conduct regulation depends, inter alia, on the scope of conduct regulated, the regulatory procedure, the experience and expertise of the regulator, and the remedy. For example, limiting only extremely high prices reduces the distortions of price signals in the market and the disincentive effects of regulation on firms to engage in genuine competition and to invest resources in order to become monopolists. It is a limited tool, however, in that it reduces harm to consumers only when prices are extremely high.

Jurisdiction*	Condemn Mere Monopoly	Structural Reg. of Mere Monopoly	Conduct Reg. of Mere Monopoly	Conduct as Abuse of Dominance	Regulation of Essential Facilities
U.S.A.					X
EU				X	X
Britain			X		X
Canada					X
Australia			X	X‡	X
Sweden				X	X
New Zealand			X		X
Israel		X	X	X	X
Malta			X	X	X
Cyprus			X	X	X

Table 4: Regulation of mere monopoly adopted by different jurisdictions

* Jurisdictions are listed in order of size

‡ Only where the monopoly is vertically integrated

It is noteworthy that conduct regulation of monopolies in small economies is evolving in a direction in which regulatory roles traditionally carried out by direct regulators are undertaken by competition authorities. Given that the traditional process of dealing with competition law violations is inappropriate to regulate the conduct of mere monopoly, many small economies entrust regulatory roles to the competition authorities and establish a highly discretionary administrative process. This implies that the borderline between regulation, which in its widest sense is aimed at correcting market imperfections in a specific industry, and competition law, which is aimed at creating and maintaining the conditions for workable competition while leaving the decisionmaking process in the hands of the

market players, are not as clearly defined as they were in the past. Yet, conduct regulation of mere monopolies is still a highly problematic tool and as such should not be lightly adopted.

3.6 AREAS OF COMPETITION POLICY NOT AFFECTED BY MARKET SIZE

To be sure, the basic economic theory and basic doctrines that serve as the basis for competition policy in large economies can apply equally in smaller ones. Although the small size of an economy may require more careful balancing among allocative, productive, and dynamic efficiencies, differences in size have no effect on many areas of competition policy. These include predominately anticompetitive practices with limited or no offsetting efficiency effects. The most striking example is the collusive conduct of a cartel that does not bring about any efficiencies by allowing its members to realize scale economies. The size of the economy need not materially affect the policy toward collusive conduct, given that such conduct is against the public interest in any economy, regardless of its size. The same is true for abuse of dominance offenses that enable incumbent monopolists to create artificial barriers to the entry of new, or the expansion of existing, competitors that are not justified by offsetting efficiencies.

It is nonetheless true that the prevalence of collusive conduct or abuse of dominance is generally much higher in small economies than large ones, due to higher industrial concentration levels and entry barriers, and that the remedies for such conduct should usually be conduct-oriented rather than structural. Offenses such as exclusive dealing, tying, and refusal to deal may affect competition more severely in a small economy (quantitatively), although the nature of the effect is similar in both large and small jurisdictions (qualitatively). To illustrate, in small economies, exclusive dealing may effectively foreclose some markets for potential competitors. For example, when a monopolistic supplier of an intermediate good undertakes not to sell its products to another distributor, a monopoly is effectively created in the market for the final goods—a situation tantamount to vertical integration. As many more markets in the small economy are monopolistic, exclusive dealing has stronger effects on a small economy than on a larger, less concentrated one. By a series of regional exclusive dealing contracts with major wholesalers or retailers, a manufacturer in a concentrated market can make entry of new firms into the industry more difficult and can even drive existing firms out of it. Exclusive dealing contracts may also serve to blockade competing imports. In large economies, on the other hand, the effect of exclusive dealing is

usually much more limited. “[I]n large economies concentration ratios are, as a rule, considerably lower than in small economies, so that exclusive dealing by one or two leading firms will still leave to their competitors a sufficient number of uncommitted distributors.”⁷⁹

Some anticompetitive offenses, such as resale price maintenance, are nonetheless likely to have similar effects (both qualitative and quantitative) on small and large economies alike. In the retail trade, the relevant market for competition is seldom the national market. Thus, retail trade in small economies can be nearly as competitive as in large economies without being less efficient. Economies of scale in retail trade, in particular at the store level, are rather limited and can be exhausted by small firms. If we view resale price maintenance as anticompetitive,⁸⁰ there is no economic reason to treat it differently in small and large economies.⁸¹

CHAPTER 4: CONCLUSIONS—THE PROBLEMATIC ADOPTION OF COMPETITION LAWS OF LARGER JURISDICTIONS AND THE IMPLICATIONS ON GLOBALIZATION OF COMPETITION POLICY

As this article has shown, the size of an economy significantly affects its optimal competition policy. The high concentration levels and high entry barriers into many industries in small economies often require a different balancing of competition considerations than is required in large ones. The thread that connects all of the strands of this article is the greater need to recognize the inevitability of concentrated market structures protected by high entry barriers in many industries in small economies. This necessitates a more refined trade-off between production constraints on the number of sellers and the assumed undesirability of certain types of conduct created by high degrees of concentration for allocative and dynamic efficiency. Most of the effects of small size necessitate small but important changes to existing doctrines, legal presumptions, or modes of enforcement adopted from large economies. Other changes involve the adoption of regulatory methods that are absent from large economies.

79. Michael Shefer, *Guidelines for Legislation on Monopolies and Restrictive Practices in Small Economies*, 15 ANTITRUST BULL. 781, 793 (1970).

80. Although resale price maintenance has been treated as a per se offense in many jurisdictions, in recent years some economists have challenged the view that it does not carry with it at least some efficiencies. See, e.g., David A. Butz, *Retailers as Informed Market-Makers: Inventory Management and Resale Price Maintenance* (1997) (paper presented at the law and economic workshop at Columbia University).

81. See Shefer, *supra* note 79, at 795.

This conclusion has important implications for the adoption of the laws of large jurisdictions by small ones. Adoption or reliance on the statutes and established case law of large jurisdictions has many recognizable advantages, such as a ready basis for the law and a large body of comprehensive case law and commentary. It also creates network externalities—as more decisions that apply the law to various factual settings begin to accumulate, legal certainty is increased.

This certainty is especially important in the area of competition law, which is characterized by elastic and open-ended notions. EU and U.S. competition law—the most widely used competition laws—are worth more than their face value to other jurisdictions, as judged by the clarity and comprehensibility of their provisions and current case law. This is especially true since some small economies cannot generate the case law needed to refine their own laws.

Accordingly, many small economies have adopted the statutes and regulations of large jurisdictions and refer to the large jurisdictions' case law for interpretation.⁸² Yet, the adoption of the laws of large jurisdictions has pitfalls. As this Article demonstrates, the most important drawback is that insufficient weight is given to the special characteristics of the small economy, which differ significantly from those of larger ones. Although many economies of all sizes rely on the market as a method to regulate economic activity, where the conditions for the effective and efficient operation of a market differ, competition law should account for these differences. The challenge is to adapt the doctrines established in large economies to the unique economic environment of the small one.

This Article also sharpens the question, which has been the focus of recent debates: Can competition law be harmonized on a global basis? The recent trend toward worldwide unification of competition law often presumes that competition policies of all jurisdictions would have been

82. The most widely adopted competition laws are Articles 85 and 86 of the EU's *Treaty of Rome* and the main regulations issued by the European Commission. The following is a partial list of jurisdictions that have adopted, in full or in part, EU competition laws: Luxembourg, Switzerland, Sweden, Finland, Malta, Jamaica, Ireland, Cyprus, Denmark, and Israel. The EU has also been able to influence the development of competition policy in Eastern Europe through trade agreements with the Czech Republic, Hungary, the Slovak Republic, and Poland. The signatories to these agreements agree to apply competition law to business practices that affect trade within the treaty's area in conformity with EU laws. See *Treaty of Rome (1957)* as amended by *Treaty Establishing the European Community*, Feb. 7, 1992, art. 85–86, 1992 O.J. C224.

similar, absent political or social goals that impinge on efficiency-based policy prescriptions.⁸³

An important consideration in favor of harmonization is a reduction in compliance costs. A patchwork of national antitrust rules has become a barrier to international business. Expanding trade by reducing multiple compliance costs may permit the realization of economies of scale in production and distribution, the attainment of network efficiencies, and the realization of regulatory economies. Harmonization also ensures that domestic exporting firms operating in a foreign market will not be subject to different rules of conduct than foreign firms operating in their home market.

Several premises, however, motivate a relatively cautious view toward trade-policy-driven harmonization. In order to achieve clear and unified rules, jurisdictions would be required to adopt similar competition rules, and to ensure their harmonized interpretation and application. Given the ability of larger, more dominant nations to impress their will on smaller jurisdictions, such negotiations carry a serious risk of grossly discounting the domestic considerations of smaller, weaker economies.

Accordingly, this Article argues for a relatively cautious approach to competition law harmonization or convergence. A bedrock of principles that could accommodate different shades of competition policy may be welfare-enhancing for small economies. The differences in optimal competition policy between large and small economies may necessitate the adoption of rules that are flexible enough to apply without jeopardizing the special interests of small economies, while at the same time creating a clear framework within which firms can operate. Otherwise, the costs of policy convergence or equivalence may well outweigh its benefits and reduce domestic welfare.

83. See, e.g., Committee on the United States in a Global Economy, *Harmonizing and Coordinating the Economic Laws of Nations: A Comparative Study*, 49 REC. ASS'N. B. CITY N.Y. 800 (1994).