COMPETITION & REGULATION TIMES

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WILL THE REAL EFFECTS OF COLLUSION ON ECONOMIC PERFORMANCE PLEASE STAND UP

Most economists believe that the foremost role of competition law and regulation is to facilitate an economy's dynamic performance. By this they mean that competition law and regulation should encourage a commercial environment where investment decisions and the uptake of new technology provide, at reasonable prices and into the forseeable future, the quantity and variety of goods that consumers value.

The difficulty for competition law is to judge the desirability of commercial activities that pose a trade-off between consumer benefits today and consumer benefits in the future. The classic example is the "regulation" that allows patents. If patents were suddenly eliminated, the prices of products – such as pharmaceuticals – which have a large research and development component, would be lowered with the rapid entry of duplicate products. Consumers would benefit today from lower prices for existing drugs. But consumers would lose in the future because of the slower development of new drugs which may have the potential to benefit them greatly in years to come. Economic calculations of the cost of delays in introducing new products indicate that the social cost can be very substantial indeed. It is much more difficult to estimate the benefits directly

EDITORIAL

PROFESSOR LEWIS EVANS

attributable to patents which facilitate research and development into new products.

It is no easy task for competition law to attain the right emphasis between today and the future. Estimating the effect of market dominance on efficiency today is difficult enough, but it is even more difficult to estimate the effect of market dominance today on *future* economic performance.

We tend to weigh the certain more heavily than the uncertain, so it is not surprising to find that decision-making in general is tilted in favour of knowledge of the static case. There are also incentives on those who implement our competition laws to favour – more highly than society as a whole – present efficiency over future efficiency. For these reasons, competition law is generally applied as though the world is static rather than dynamically changing. An examination of the dynamics of markets and market power might better inform commercial law policy. It is as well that, recently, there have been relevant theoretical developments.

A commercial action that almost always falls foul of competition law is collusion entailing price fixing. In New Zealand, and in other countries, collusive price fixing is illegal irrespective of the explanation given for it. This stems from the argument that consumers are disadvantaged by higher prices that result from collusion, and that the higher prices lead to too little production and consumption. This argument is static in that it looks at the situation at a point in time and ignores the interacting processes of change. The first attempt by economists to incorporate dynamic change involved posing price fixing as an explanation for price wars. The argument is that price wars may be the outcome of firms cheating on collusive agreements and attempting to punish others. However, it has proved difficult to substantiate

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this argument when firms are repeatedly interacting over time.

Recent research by Fershtman and Pakes[1] argues that competition law should be modified to weigh the social damage and benefits of collusion in determining whether price fixing should be deemed illegal.

They consider situations where there are different sorts of firms, where the economic environment unfolds over time in an unpredictable way, where entry to the industry entails some unrecoverable fixed cost, and where firms enter and leave the industry based on their performance. While these seem obvious factors to allow for, it is extremely difficult to incorporate these influences in formal logical arguments. In their model, firms co-operate in setting prices but not in choosing investments, perhaps because investments are much more difficult to observe by other firms than are prices. This situation is compared with an alternative where collusion about prices is not permitted.

Fershtman and Pakes found that, where collusion is allowed, there are typically more firms in the market because the possibility of collusion encourages firms to enter. The threat of increased entry stimulates existing firms to invest more heavily in product quality and variety in order to maintain their position. This improves the lot of consumers, but can come at the cost of higher (collusive) prices. Depending upon the state of the firms and the economy, collusion breaks down and price wars occur. A firm that knows it will shortly leave the industry has no reason to adhere to any pricing agreement. If one exists, it will cheat thereby triggering a price war. Prices are also quite unstable immediately after a new firm enters.

In their set-ups, the dynamic incentives that are provided by the possibility of collusion, such as investment, entry and exit, yield benefits to consumers that exceed the higher costs represented by periods of collusive (higher) prices. Consumers benefit from firms' unfettered access to collusion, although the overall performance of the industry – taking into account firms' profits – is not much different.

Although other outcomes will be possible, depending upon the nature of the industry, the principles remain relevant and the results do question the desirability of making the act of collusion illegal. Essentially, Fershtman and Pakes are arguing that this legal restriction is a barrier to entry that, in their set-up, reduces consumer welfare.

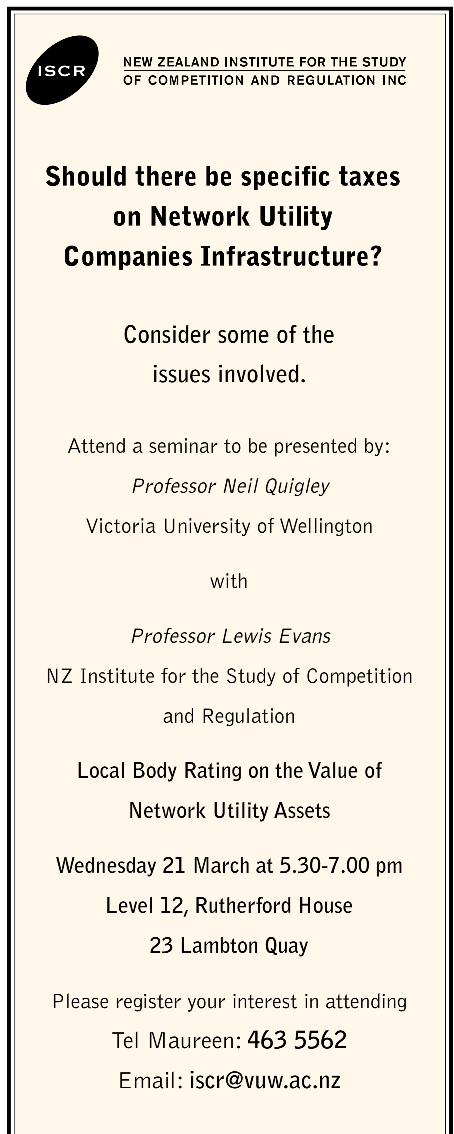
> “PRICE-COLLUSION IS NOT ALWAYS "BAD". IN THE INTERESTS OF DYNAMIC ECONOMIC PERFORMANCE, AND BEFORE IT IS AUTOMATICALLY PENALISED, IT SHOULD BE CONSIDERED ON A CASE BY CASE BASIS.”

Changes proposed for the New Zealand Commerce Act are aimed at strengthening the Act's provisions against co-operation. The proposed changes will make it easier for competition authorities to use the potential for tacit collusion as a detrimental factor in the consideration of mergers etc. Thus, collusion that results from devices that facilitate price fixing, but without an explicit agreement, would be seen as (potentially) detrimental in the assessment of potential mergers. There is no clear economic argument that this change would improve the lot of consumers. In fact, Fershtman and Pakes suggest that such changes would likely favour today's consumers at the expense of consumers of the future. Looked at through static eyes, it may appear to be a step forward. From a dynamic point of view it would be a step back.

This is not to argue that price-collusion is always good, indeed it may be detrimental. Rather it suggests that price-collusion is not always "bad" and that in the interests of dynamic economic performance, and before it is automatically penalised, it should be considered on a case by case basis.

Prof Lewis Evans is Executive Director of the New Zealand Institute for the Study of Competition and Regulation.

1 *"A Dynamic Oligopoly with Collusion and Price Wars", The RAND Journal of Economics, 31(2), Summer 2000.*



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RE-EDUCATING RITA

(AND MURRAY AND DEBBIE, AND GARY AND SANDRA, AND LINDA AND GRAEME)

Valentine's Day is over for another year and still no card! Judy Kavanagh contemplates the start of the new academic year and reviews her options.

Back in 1970, when the bulge of the baby boomers were transacting in the mating market for the first time, George Akerlof cracked one of the great mysteries of modern economics. For years, economists could not fathom why the value of a car falls the moment it is driven pristine and virginal out of the showroom and becomes a "used" car.

In his seminal article "The Market for Lemons"[1] Akerlof demonstrated that buyers of used cars were rationally responding to the lack of information about the quality of the vehicle in offering a significantly lower price. The risk of picking a "lemon" is much greater in the used car market than in the new car market. This is because there is a range of possible motivations for selling a car and the buyer cannot know what the true motivation is.

This is a classic information asymmetry problem between buyer and seller: Is the vehicle on the market because the vendor is going overseas (like he says he is) or is it because the vendor knows that the clutch is about to go at any moment? To compensate for the risk, buyers offer lower prices and this explains the low average price of used cars.

Sellers of good-quality used cars thus have an incentive to find innovative ways of signalling the higher quality of their cars in order to achieve a price reflecting this quality. This signal has to be credible to distinguish it from the "one careful lady owner" patter that few believe anyway.

An example of such signalling is Toyota's "Signature Class" branding of reconditioned cars. This offers a warranty that will cost Toyota if the vehicle is not up to the advertised standard.[2]

Since Akerlof solved the "lemons" mystery, the phenomenon has provided economists with a useful explanation for behaviour in a variety of markets where information asymmetry may be an impediment to market clearing.

Consider, for example, the second-time-around mating market. This market is potentially sizeable, with a third of the couples who married in 1973 now divorced. Some of these singles will want to signal that they are "in the market" for another relationship.

There are many ways one might attempt this. Listing with a dating agency is one possibility. But before market participants try this avenue, it is worth considering what kinds of people might also be participating in the market.

First, they have signalled their availability as surely as if they had parked their cars on Paremata Esplanade on a Saturday morning with a 'for sale' sign in the front window. Second, it can be assumed that a great proportion of these people will have been unsuccessful in making a "sale" using other avenues. To be blunt, dating agencies may be markets for lemons.

What can a bright, intelligent, successful, 40-something SINBAD[3] do? Answer: Head back to (graduate) school. Suddenly, the teachers don't seem so old. Fellow students, although they may be a bit wider around the girth, will at least have their own transport (unless the kids have borrowed the car for the evening).

Going back to school signals that you are intelligent, motivated, open to new ideas and career-minded. This is likely to be a much preferred message for the second-time-around-er to send.

The signal is also credible because it is costly to fake: it takes brains, commitment and a certain endurance to survive a Graduate School Programme like Victoria University's MBA or Master of Public Management degree.

Could this explain the rise in popularity of MBA programmes and second-chance education generally? It may not be the complete answer. But, more importantly, participants find that even if the mating thing doesn't work out, at least they gain a qualification that won't be a lemon in any market.

Judy Kavanagh teaches MMPM 503: *Economic Principles and Policies for Public Managers* for the Master of Public Management Degree at Victoria University of Wellington

1 *Akerlof, G. (1970) "The Market for Lemons" Quarterly Journal of Economics.*

2 *Of course it is the cost Toyota potentially faces if the car is not up to standard that makes the signal of quality credible. In economic terms this is often referred to as the 'costly-to-fake' principle.*

3 *Single Income, No Beau, Absolutely Desperate.*

THE COSTS OF RUNNING SCARED OF RUNNING LATE

Bronwyn Howell and Judy Kavanagh highlight the need for incentive-based cost-benefit analyses of legislative and regulatory intervention.

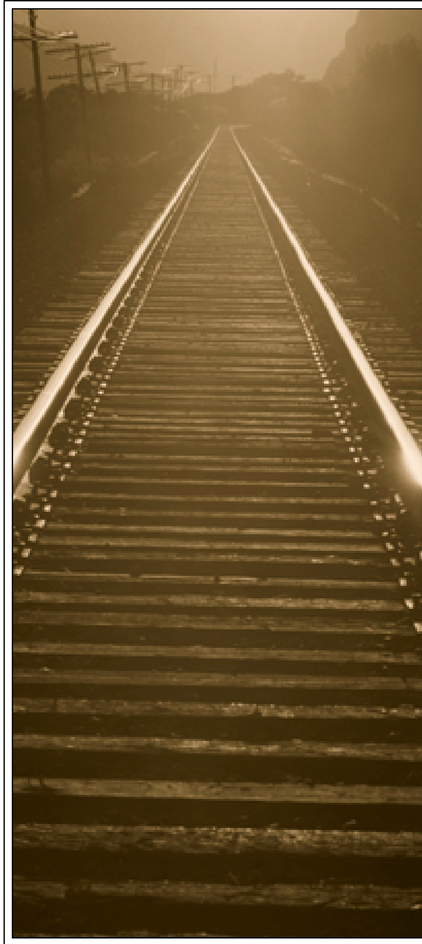
On October 17 2000, a train derailment at Hatfield near London claimed the lives of four passengers. The report on the accident by the British Health and Safety Executive states that "all the evidence points to the derailment having been caused by fracture and subsequent fragmentation of a rail".[1] Many other statutory authorities are also investigating the accident and criminal proceedings are likely. The British public will want to know who to blame.

In New Zealand, similar investigations have followed tragedies such as Cave Creek and Erebus. In both these cases, procedural inadequacies, and a limited understanding of their wider-reaching impacts, were found to be significant causal factors in the loss of life.

In the Cave Creek case, initial findings pointed to substandard workmanship and materials as the immediate cause of the platform collapse. Further analysis, however, revealed that the use of poor workmanship and materials was a consequence of inadequate processes within the Department of Conservation, and between the Department and the Minister. Similarly, Justice Mahon identified inadequate procedures within Air New Zealand as relevant factors in the Erebus disaster.

Without pre-empting the ultimate findings of investigations in Britain, it would appear that an analysis of the British rail system's procedural and contractual environment may offer deeper insights into the fundamental causes of the Hatfield derailment and provide important lessons for public safety. These insights may be instructive for New Zealand, given that the legislation governing New Zealand railways is being reviewed in anticipation of the sale of portions of Tranz Rail's operating activities.

The British investigation is likely to scrutinise the role of the Office of the Rail Regulator (ORR) and its ability to influence the contractual relationships of the infrastructure-owner



Railtrack with both track maintenance sub-contractors and train operators. Railtrack owns the rails and sub-contracts maintenance to other firms. Train operators contract with Railtrack for access to the tracks to run train services. The ORR acts as the regulator over the access contracts and specifies the operating conditions for train operators to hold licenses to offer services (see Figure 1).

The ORR's mandate specifically requires it to consider customer perspectives in making and enforcing regulations. As part of the licensing process, the ORR requires train operators to meet performance targets for comfort, reliability (that is, that services run to scheduled times) and cleanliness.

The ORR has been vigilant in enforcing these requirements. One operator, Connex, had its license withdrawn for failing to meet the required standards. Further, the ORR requires both Railtrack and train operators to meet specified safety standards, covering both track condition and rolling stock. In short, UK rail is extensively regulated with respect to the services provided, the prices charged and specific safety factors.

In the absence of the ORR's intervention, one could expect that Railtrack and the train operators would negotiate contracts specifying terms and conditions, including redress in the event terms were breached. For instance, if Railtrack's activities resulted in delays to trains, then compensation would be expected to be paid by Railtrack to the train operators. Conversely, compensation for contingencies not anticipated at negotiation, such as a growth in operator train size increasing wear and tear on the tracks necessitating increased maintenance work, would be payable to Railtrack by the train operator.

However, in the British regulatory environment, the ORR not only has the ability to specify terms and conditions for Railtrack-train operator contracts, but also to enforce terms. This means it can impose penalties in addition to any contractual remedies should the terms be breached.

In the Hatfield case, the action of the ORR in imposing a penalty on Railtrack for failing to achieve specified reductions in average delays caused to trains may be an important factor. On August 19 1999, the ORR responded to the public's requirement for timely train services by giving notice under section 56 of the Railways Act 1993 that it would impose a penalty on Railtrack should it fail to reduce delays. The penalty would be £400,000 for each one-tenth of a percentage point by which Railtrack failed to achieve a 12.7% reduction in Railtrack-caused delays in 1999-2000. Delays would be calculated in minutes per passenger train.

It is acknowledged that train delays are costly to travelling passengers, and that the ORR had a mandate to prioritise the interests of travelling passengers highly when making this ruling. However, it is unclear from the submissions and supporting documentation associated with the setting of the penalty whether a full incentive-based and proper cost-benefit analysis had

been conducted encompassing the effects on all stakeholders in the industry.

The new penalty, in addition to any compensation Railtrack was already paying to train operators, realigned the incentives associated with undertaking track inspection and maintenance. The principal causes of train delay attributable to Railtrack relate to poor track standard, which limits the speed at which trains can travel, and hold ups of trains caused by track work. There was evidence that, even prior to the ORR penalty imposition, the ability to undertake track maintenance was being impaired by the difficulties that maintenance crews encountered getting access to the tracks.

In 1999, the Transportation Technology Center of Colorado, USA[2] undertook research on behalf of the ORR. The Center states that both Railtrack and its maintenance sub-contractors "stressed that managing a reduction in broken rails was made much more difficult by the need to plan possessions [that is, access to the rails] up to 42 weeks in advance". Thus, there is evidence suggesting that Railtrack was already incentivised to defer track work in order to keep the trains running on time by the compensation clauses in its contracts with train operators. The penalty imposition would have served to increase the strength of this incentive.

Four lives were lost at Hatfield, which is tragic for the families involved. But this loss must be set against the gains to the travelling public stemming from reduced delays. Timely train services have undoubtedly contributed to the estimated 48% increase in the patronage of rail services since privatisation. This, in turn, is likely to have contributed to a significant reduction in road traffic, reducing both congestion and the costs of road crashes including injury, property damage, and loss of life.

> "FOUR LIVES WERE LOST AT HATFIELD, BUT THIS LOSS MUST BE SET AGAINST THE GAINS FROM REDUCED DELAYS. TIMELY TRAIN SERVICES HAVE CONTRIBUTED TO THE INCREASE IN PATRONAGE OF RAIL SERVICES. THIS IS LIKELY TO HAVE REDUCED THE COSTS OF ROAD CRASHES INCLUDING LOSS OF LIFE."

Clearly, therefore, the costs and benefits of the ORR's actions impact more widely than just the rail sector. Its actions have the ability to shift both cost and risk outside of its ambit. In the case of the train-delay penalty, benefits may have accrued to the entire travelling public, but the costs and the risks were transferred only to Railtrack and rail travellers.

It is possible that the ORR set the penalty at the optimal level. This, however, can never be determined, as no analysis was undertaken of the dynamic effects of the penalty and the consequent changes to the incentives faced by all stakeholders: Railtrack, its maintenance sub-contractors, train operators, the ORR, the travelling public (road and rail), politicians and the voting public. Further, there is no evidence of such an analysis being undertaken of the reformed structures at the time that the regulatory structure was imposed[3]. Had such an analysis been undertaken, there would have been greater understanding of the underlying factors that contributed to the Hatfield derailment.

Moreover, such analysis might have brought to the surface controversial issues surrounding the role and accountabilities of a collective "consumer advocate" that has the power to make regulatory decisions over an industry. Passengers and freight customers can signal

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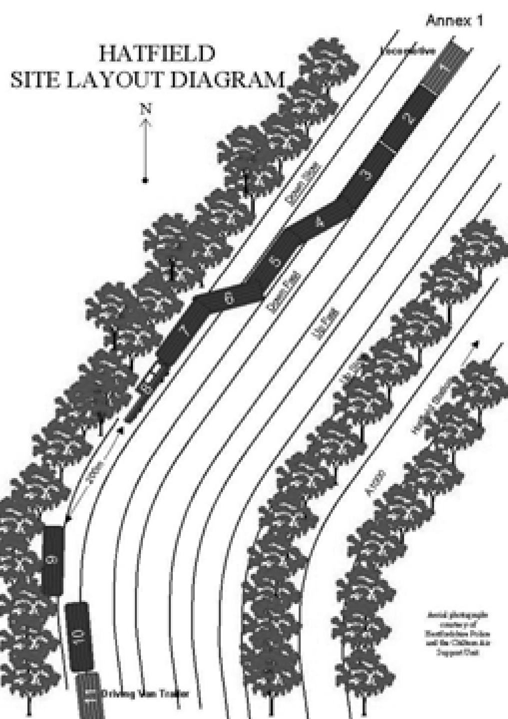
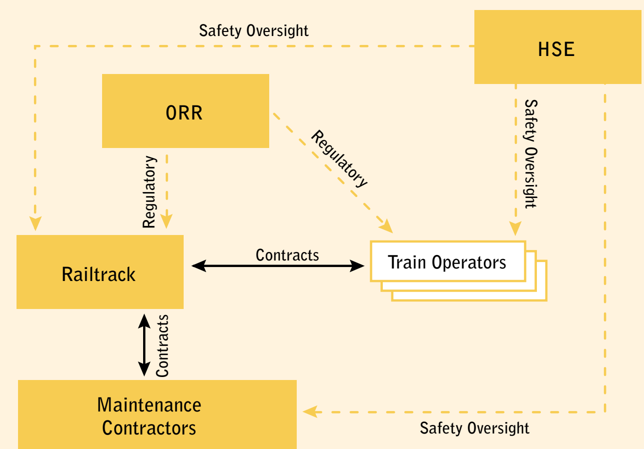




THE ECONOMIC PERFORMANCE OF NEW ZEALAND RAIL

In 1993, the New Zealand Government sold its interests in rail to a consortium of private sector owners. Eight years on, Tranz Rail is itself proposing to sell sections of its operations to new owners. Among interested potential buyers are both central and local government interests. If they are successful, we will have gone full circle with the transfer of the ownership of some operations back into public hands.

An ISCR report[1] on the economic performance of New Zealand railways up until 1997 – covering periods of both public and private ownership – finds that productivity improved during periods of corporate-style management. Even so, the report finds, rail has been unable to cover the cost of capital.

Unlike accounting profit, *economic* profit accounts for the replacement cost of capital on an annual basis. To do so, the ISCR study applied a model of the rail network and rolling stock that has been used by railways as a management tool to price the replacement cost of capital in each year. Measuring capital at replacement cost is desirable because if the company is not covering this cost then it cannot afford to maintain its capital into the future. It must revise its operational activities or implement productivity improvements to stay in business.

In 1997, the replacement capital cost was $1,500 million. Despite rail's improved operating performance in the 1990s, the ISCR study found that rail has not been able to cover the replacement cost of its capital going back as far as 1983. Indeed, historical operating revenue and cost data suggest that this has been the case since the early 1940s.

Rail's financial performance is shown in Figure 1 that shows profit before deducting the cost of capital. Figure 1 also illustrates an association between attempts to impose corporate-style management on rail, while still under public ownership, and improvements in financial performance. These restructurings had a familiar ring. Their objective was to focus rail management more acutely on business objectives, to limit political intervention, and to control costs. The data suggest that none of these attempts, nor the financial improvement that followed, appear to have been sustainable. Rail, unlike Telecom and New Zealand Post, was never a State-Owned Enterprise, yet the SOE model arguably offers a structure through which state-owned trading firms have the best chance of performing well against commercial objectives[2].

> "THE PROPOSAL OF SOME RAIL FACILITIES BEING TRANSFERRED INTO LOCAL REGIONAL OWNERSHIP DOES OFFER THE PROSPECT OF AT LEAST SOME EFFICIENCIES OVER NATIONAL GOVERNMENT OWNERSHIP OF RAILWAYS. LOCAL OWNERSHIP MAY ENCOURAGE THE ASSESSMENT OF THE COSTS AND BENEFITS IN RAIL AS OPPOSED TO INVESTMENT IN OTHER TRANSPORT OPTIONS."

Figure 2 shows changes in the total productivity of rail. A percentage reduction in the cost of producing a defined amount of output is the result of organisational performance improvements and changes in the quality and quantity of inputs used to produce that output. Total productivity growth of 80% between 1983 and 1997 implies that the cost of producing output in 1997 would have been 80% lower than the cost of producing the same output 14 years earlier. Although it is derived independently, rail's productivity improvement closely follows improvements in financial performance.

Railways' commitment to privatisation of the core business began in 1989, although the Board was not given the green light to sell until 1992. The study shows that the productivity and profit improvements date from this commitment rather than from the time of sale. Prior to 1989, the productivity figures show the familiar rail corporatisation story of initial improvement followed by decline. Indeed, the calculated benefits of rail privatisation exceed the costs irrespective of which year, 1989 or 1993, is assumed as the start of privatisation.

In the case of railways in New Zealand, corporatisation under state ownership has produced productivity improvements but these have not proved sustainable. Productivity improvements that followed privatisation have been insufficient to enable capital costs to be covered. This may underpin Tranz Rail's current interest in divesting some of its operations. It should also ring warning bells for Government.

If the prices of other forms of transport properly reflect the social cost of the resources they use, then a negative economic profit for rail implies that society values rail services less than the resources they use. If this is the case, it is in the public interest for rail to change its operational activities and/or improve its productivity.

However, the validity of this argument relies upon road and sea transport operators, including private motorists, paying the full economic cost of the resources they use. It is debatable whether this is true in New Zealand. If the pricing of other transport infrastructure, such as roading, does not include the cost of capital, it will also be under-priced relative to rail, and will also lead to inefficient investment decisions. For a full comparative analysis of transport modes to be valid, other factors such as their environmental impact should also be included.

Further, the ISCR study highlights the implications of failing to account for the cost of capital in running state businesses. Capital is a real cost and ignoring it means that the taxpayer is forced to subsidise commercial activity. Subsidies from general taxation engender

welfare losses over and above their dollar amount because taxation distorts resource allocation in the economy and creates a deadweight loss. Furthermore, the funds represented by losses have substantial value in alternative uses. The amount the government put into railways as an owner – ignoring passenger subsidies – from 1983 to 1989 would have built between three and four Transmission Gully roads or the same number of mega-hospitals like the ones proposed for Auckland.

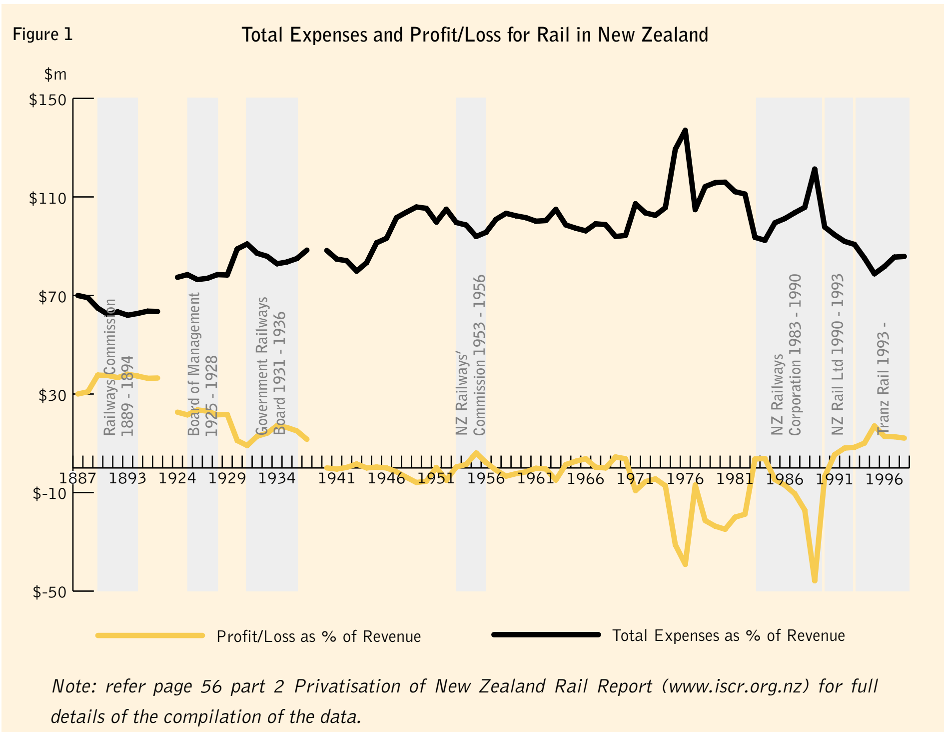
There appears to be no reason in this case why the cost of capital should not be covered by purchasers of all transport services. To do otherwise will lead to poor investment decisions. The proposal of some rail facilities being transferred into local regional ownership does offer the prospect of at least some efficiencies over national government ownership of railways. Local ownership may encourage the assessment of the costs and benefits in rail as opposed to investment in other transport options, such as new roads. It may give local bodies a stimulus to charge road users the full cost of roads use, especially congested commuter routes.

If components of Tranz Rail's operations return to public ownership, it will be important that they viably cover all their costs. There would seem to be no case for net taxpayer subsidy. If the stress on railways is resulting from mis-pricing other forms of transport, it is the mis-pricing that should be addressed.

1 *"The Privatisation of New Zealand Rail", available at www.iscr.org.nz*

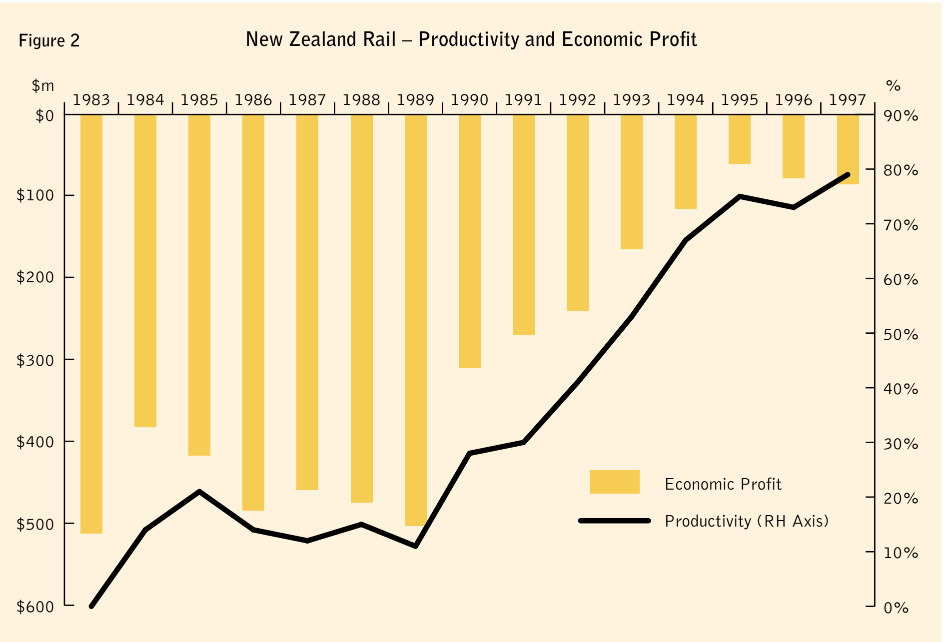
2 *Refer Competition and Regulation Times, Issue 3, December 2000.*

Figure 1 Total Expenses and Profit/Loss for Rail in New Zealand



Note: refer page 56 part 2 Privatisation of New Zealand Rail Report (www.iscr.org.nz) for full details of the compilation of the data.

Figure 2 New Zealand Rail – Productivity and Economic Profit



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their preferences, and hence their satisfaction with train services, by their patronage. Dissatisfied customers can discipline poor provision by opting to use other transport modes. This raises the question of why a consumer advocate should be necessary.

The existence of an advocate effectively enables whomever that advocate represents to influence the industry. If it is customers, then the advocate enables customers to dispense a double dose of discipline on the industry. However, while the rationale for such advocates may be to represent collective *consumer* interests, advocates may in fact represent the interests of other stakeholders who are unable to express their preferences via market signals, such as the government that designed the regulatory scheme. Whether the collective consumer advocacy of the ORR promoted the optimal incentives for British rail performance will be a matter for assessment.

The lesson for New Zealand is clear. Changes to our railways legislation will inevitably change the nature of the relationships between stakeholders in the entire transport sector and the incentives they face. This warrants careful analysis prior to enactment in order to avoid the unexpected cost-shifting, risk-shifting and ultimately blame-shifting which has emerged in the wake of Hatfield.

1 *Health and Safety Executive (2001) Train Derailment at Hatfield, 17 October 2000: Second HSE Interim Report. http://www.hse.gov.uk/railway/hatfield/interim2.htm*

2 *Sawley, K; and R Reiff. (2000) Rail Failure Assessment for the Office of the Rail Regulator. Colorado, USA: Transportation Technology Center, Inc.*

3 *Freeman, R; and J Shaw. (2000) All Change: British Railway Privatisation, McGraw Hill.*

COMPETITION LAW AND CER

GUEST ARTICLE

An extract from a paper presented by Kerrin M Vautier to last year's conference on *Competition Law at the Turn of the Century.*[1]

The 1983 Australia/New Zealand Closer Economic Relations Agreement included the obligation "where appropriate, to encourage working towards [business law] harmonisation". This has undoubtedly been an important influence on the harmonisation of the two national competition laws, starting with the introduction of New Zealand's Commerce Act 1986. It is generally accepted that the two statutes are broadly harmonised and the two CER members now have the highest level of competition law convergence of any pair of countries in the Asia/Pacific Region.[2]

The trans-Tasman competition provisions which were introduced simultaneously in 1990 – s.36A (New Zealand) and s.46A (Australia) – together with some related enforcement provisions, gave some explicit although not identical extra-territorial reach to the two statutes. The jurisdiction for each country's unilateral use of market power provisions was extended, so that redress is available to actual and potential competitors in any "impact market" in New Zealand or Australia in respect of proscribed conduct by a powerful firm that originates in any trans-Tasman market. But, unlike the parent provisions – s.36 (New Zealand) and s.46 (Australia) – the proscribed conduct is limited to goods. With the exclusion of services and the otherwise limited scope of the trans-Tasman competition provisions, their reach is narrow.

By and large the CER partners have retained their separate competition laws and national jurisdictions, along with their discretion to diverge from time to time[3] as well as converge. They have not embraced the idea of a trans-Tasman Court or Tribunal, nor that of conferring jurisdiction on the High Court of Australia

to hear trans-Tasman competition disputes.[4] The 1990 trans-Tasman provisions also fall far short of a comprehensive trans-Tasman competition law. Even assuming that direction were appropriate, there is nothing on the previous or present reform agendas to suggest that this is being contemplated.

Conformity of the Commerce Act with Australia's Trade Practices Act will increase as a result of New Zealand's present reform proposals to "strengthen" the Commerce Act.[5] In the contexts of s.36 and of business acquisitions, ministers are clearly favouring the option put to them by officials "of adopting the equivalent approach in Australia"[6].

There is certainly room for debate on the issue of regulatory harmonisation versus regulatory competition. The history of the harmonisation debate within CER has been well documented[7] and is relevant for other country groupings where the harmonisation of competition laws is often promoted as the 'solution', albeit to ill-defined problems. Suffice it to say that the rationale for harmonisation has always been shaky, especially from an economics perspective. Essentially it has relied upon assertions of resultant business certainty, reduced transaction/compliance costs and trade enhancement in the context of 'a single market'.

But *ex post* verification of a positive correlation between harmonisation and, in particular, lower impediments to trade, has been lacking and such assertions have become more muted.

In any event, despite the rhetoric of a 'single market' and economic integration within it, trans-Tasman trade transactions comprise a relatively small part of total commercial activity and trade for each of the CER member countries. The conclusion reached ten years ago in Vautier (1990) still stands:

"Continuing vigilance as to the relevance and soundness of all competition rules in an Australasian context ... is most likely to be compatible with CER objectives. Promotion of the competitive process and of efficiency is more important than consistency *per se*."

Currently the emphasis of New Zealand's Coalition Government is on Australia being "our closest trading partner". In the context of adopting Australia's s.46 competition threshold for s.36 of the Commerce Act, New Zealand also puts emphasis on:

"a new policy objective of seeking to capture a larger number of firms and markets within the purview of [s.36] ... [which] will also increase the level of harmonisation with Australia and may lead to benefits of reduced compliance for businesses operating in both countries and shared case law development."

Further, the relevant minister sees advantage in replacing the s.36 words "use of" with "take advantage of" as in s.46 of the Trade Practices Act:

"[This] would indicate to the Courts some dissatisfaction by Parliament with the past interpretation of 'use' without needing to attempt to define precisely the deficiencies in its present interpretation by inserting a new set of words."[8]

"Strengthening" the Commerce Act by reference to Australia's competition law, as distinct from an objective of harmonisation with Australia's law, is being presented as the primary driver for New Zealand's latest competition law reforms. But, at the same time, given the nature of the statutory changes proposed

and the explicit rationale for them, there seems little doubt that Australia's jurisprudence will be given more weight at decision-making levels.

In summary, there have been four key influences on competition law developments under CER:

- firstly, since 1983 a broad obligation on the two members to work towards business law harmonisation;
- secondly, the 1990 trans-Tasman competition provisions along with removal of the anti-dumping remedy in respect of trans-Tasman trade;
- thirdly, the "new policy objective" of "strengthening" the Commerce Act by reference to Australia's Trade Practices Act; and,
- fourthly, the general unwillingness of the CER partners to create specific trans-Tasman institutions to deal with CER issues, including any relating to competition.

As a result of all four influences:

- Australia and New Zealand have very similar competition law statutes (more so in the future), especially by international standards, each with a fairly prominent place within similar legal systems;
- Australia and New Zealand have the highest level of competition law convergence of any pair of APEC economies;
- there is a general expectation (at least in New Zealand) that determinations in each CER member country will increasingly adhere to statutory interpretations in the other, although there will be no obligation to do so especially where there is a wider base of jurisprudence to draw from;
- both laws have limited extra-territorial reach;
- there are no supra-national institutional arrangements specific to competition law adjudication; and,
- CER members have each retained their discretion to engage in regulatory competition from time to time, bearing in mind that pushing the harmonisation objective too far can itself work against the competitive order.

One of the most important questions arising out of all of this is why the trans-Tasman reach of the two national laws has not been extended beyond the s.36A and s.46A provisions and particularly to trans-Tasman contracts arrangements and understandings that substantially lessen competition in a relevant impact market. The most likely explanation is that the 1990 trans-Tasman competition provisions were solely for the purpose of effecting the removal of the trans-Tasman anti-dumping remedy – at the same time as free trade in goods and most services was achieved – and were never intended to give rise to wider extra-territorial reach.

This interpretation is supported by the fact, mentioned above that unlike their parent provisions s.36A and s.46A do not cover services. This is akin to the goods-only coverage of the anti-dumping laws that were repealed. As Lloyd and Vautier (1999, p.89) concluded:

"The trans-Tasman competition provisions were clearly driven more by the residual price discrimination concern than by any broader policy objective to apply a competition standard to all forms of conduct affecting all trans-Tasman trade. Given their limited scope, it seems clear that the new provisions were promulgated more with a view to assuaging the fears of domestic manufacturers over the loss of the trans-Tasman anti-dumping remedy than with a view to having a comprehensive trans-Tasman competition law.

A broad-based trans-Tasman competition law was neither the main achievement nor the main objective of the 1990 amendments. Such a shift in policy would have required a much more comprehensive approach to the application of competition law to trans-Tasman trade. It would have required extension of the trans-Tasman provisions to collusive price-fixing and other contracts and arrangements (such as trans-Tasman market sharing) which have the purpose or effect of substantially lessening competition in an impact market and to cover vertical practices and mergers. For example, any collusion between actual or potential competitors across the Tasman should be treated as seriously as collusive conduct prohibited within each of the national jurisdictions. It appears, however, that these issues are not presently a high priority for either policymakers or the enforcement agencies."

These conclusions still stand. It has not been an aim of the harmonising and strengthening motivations for amending our laws (notably in New Zealand) to have a comprehensive trans-Tasman competition law covering a wide range of possible trans-Tasman practices such as market sharing. Nor, with the limited exception accompanying the 1990 trans-Tasman provisions, has the target been trans-Tasman enforcement co-operation – although, arguably, harmonisation could provide a stronger basis for such co-operation.

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Lloyd, P.J; and K.M. Vautier (1999) "Promoting Competition in Global Markets – A Multi-National Approach", Edward Elgar Publishing Ltd, England.

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1 *The full paper will shortly be available in the conference papers due for publication later this year.*

2 *Bollard, A. and K.M. Vautier (1998), "The Convergence of Competition Law within APEC and the CER agreement", in Wu, Rong-I and Yun-Peng Chu (Eds), Business, Markets and Government in the Asia Pacific, Routledge.*

3 *For example, the 'essential services' access regime in Australia's Trade Practices Act is not a feature of the Commerce Act; and New Zealand's present proposal to empower the Commerce Commission to issue cease and desist orders does not mirror any such general power in Australia's Act.*

4 *"I do not think that New Zealanders would ever agree (or outside a federation should agree) to surrendering final decisions on their legal matters to the High Court of Australia. Yet the Australian Constitution makes the birth of a hybrid court for Australasia impossible without major constitutional amendments, difficult to procure." The Hon Justice MD Kirby (undated), "The Trans-Tasman Relationship", Institute of Policy Studies.*

5 *The author notes that the Commerce Select Committee has referred the Commerce Amendment Bill back to the House after not being able to agree on the reform proposals.*

6 *APEC (2000), "Strengthening Competition Law in New Zealand", presentaion by New Zealand APEC Officials at Competition Policy and Deregulation Workshop, Senior Officials Meeting 2, 27-28 May.*

7 *See, for example, Vautier, Farmer, Baxt (1990).*

8 *Office of the Acting Minister of Commerce (2000, undated), "Strengthening the Commerce Act's Prohibition against the Misuse of a Dominant Position".*

INFORMATION SERVICE PROVISION
SHOULD IT BE GST-EXEMPT?

Collecting GST from Internet Service Providers (ISPs) will be increasingly expensive, complex and distortionary in a global market. Much larger national economic gains are available by exempting them, in line with the treatment of financial services, according to a new paper by ISCR's Brownyn Howell.[1]

As previously reported in *Competition & Regulation Times*[2], New Zealand's real cost of Internet service delivery is lower than Australia's. It is technically practicable now to route point-to-point calls in other countries through New Zealand, using a New Zealand ISP. The basis exists for a significant new export industry.

The issue for New Zealand is that the international cost advantage of the industry is highly vulnerable to the unusually large administrative costs that can be very easily generated by inappropriate or distortionary consumption tax treatment of international electronic transactions.

It is recognised worldwide that consumption tax on electronic transactions is a difficult area. In New Zealand, the Inland Revenue Department, aware of the potential size of the administrative and compliance cost burden, is still considering its policy approach.

The New Zealand Goods and Services Act 1985 was written before the Internet developed and was therefore not designed with international electronic transactions in mind. An imprecision in Section 11 2(e) creates a crucial ambiguity which the IRD has yet to finally resolve.

The section provides for GST levying on services performed in New Zealand and subsequently exported. Consistent application of this section is problematic. If it relates to tangible property that is physically present in New Zealand – such as a commission on a real estate valuation – GST of 12.5% is levied, even if the purchaser is resident offshore and the report is exported.

> "WE CAN HAVE A SYSTEM THAT ENCOURAGES OUR ISPS TO EXPORT SERVICES AND THAT ATTRACTS FOREIGN ISPS TO LOCATE IN THIS COUNTRY. OR WE CAN HAVE A SYSTEM THAT ENCOURAGES OUR ISPS TO LOCATE OVERSEAS AND THAT ASSISTS FOREIGN-BASED ISPS TO CAPTURE THE BUSINESS IN NEW ZEALAND."

However, if it relates to property that is only temporarily present in New Zealand – such as a blood sample sent here for analysis and subsequently returned – the exported pathology report is zero-rated.

ISPs transfer information to non-residents consuming the service offshore. On that basis, the service should, like other exports of goods and services, be zero-rated. But the *transfer*, as distinct from the consumption of the information transferred, occurs on servers in New Zealand. Is it, then, provided "directly in relation to tangible property" in New Zealand?

Global electronic development is moving very fast. The development of our ISP industry can be impeded or distorted if the tax environment remains unclear or unfavourable. Major export opportunities can be lost. The problem needs to be resolved urgently.

Precedents exist in New Zealand in comparable areas for taxing and for zero-rating. IRD zero-rates telecommunications-industry electronic transfers down fibre-optic cables to a foreign recipient. But it levies GST on education services provided here to foreign students who leave this country as soon as the information transfer process is complete.

Should electronic information transfers be taxed, like most other goods and services? Should it be zero-rated, like most other exports? Even if this question can be resolved, yet another anomaly is raised by the exemption from GST, as opposed to zero-rating, of financial services. Do electronic information transfers more closely resemble financial transactions than transfers of conventional goods or services, and therefore warrant exemption on those grounds?

A systematic review of the evidence suggests that exemption is sound in principle, more practicable than taxing or zero rating and less onerous in its compliance costs. It is also likely to deliver over time much larger economic and social benefits to the nation as a whole.

The downside of imposing GST on electronic transfers is two-fold.

First, the tax would erode the advantage of New Zealand's cheaper provision in export markets where ISPs are not liable to consumption tax, or are taxed at a lower rate. Australia's GST rate is, for example, 11.12% lower than the New Zealand rate. The incentive for New Zealand ISPs to seek export business would be reduced. Australian consumers would be encouraged to use a service that is less efficient, in a global market sense.

Secondly, ISPs in other countries, where they pay no consumption tax or pay at a rate lower than ours, would improve their competitive advantage in this country. They would be encouraged to offer foreign ISP services to New Zealand residents, based on servers in other countries. We lose our export opportunity, but our foreign rivals gain one here.

In those circumstances, the only efficient response by New Zealand ISPs is to relocate abroad, preferably in countries such as Pakistan, where no consumption tax is levied. If so, then New Zealand doesn't just lose exports. We lose a valuable industry. Costs to the Government would then include not just the GST involved, but also the company tax, income tax on the shareholders and employees, and the industry's contribution to New Zealand's GDP.

The second option, zero-rating in line with policy for most other exports, seems at first glance the obvious way to avoid economic and social penalties. Domestic consumption is taxed in the usual way. When goods pass over the border, provision is zero-rated in the exporting country to avoid imposing consumption tax in a jurisdiction where the goods have not, in fact, been consumed. The importing country, if it has such taxes, collects them as the goods cross their border to the final consumer.

The difficulty is that electronic information transfers do not pass through Customs monitoring posts at the border. They can be tracked only at the point of origin of the transmission, and at its final destination. To capture the transfer at its destination, recipients would have to register, report and collect tax from themselves on their ISP services. Independent monitoring, measuring and verification of such usage is impossible at any level of compliance and administration cost compatible with sound principles of taxation.

Alternatively, tax authorities in the consumer country might seek to extract tax in the provider country from the ISP that provided the service. That would make our ISPs tax collectors for a foreign jurisdiction. The more countries an ISP exported to, the more governments for which it would become a tax collector. Enforcement would require bilateral or multi-lateral treaties, and the compliance costs would be significant. Any jurisdiction that opted to stay outside the treaty system could attract ISPs to avoid those compliance costs by moving their operations offshore into a tax-free environment.

The practical difficulties go even deeper. When a user connects to an ISP, the user's identity is known, but the country of origin of the call may not be. It may pass through multiple countries en route, or caller-identification suppression may be specifically invoked. The ISP could advise that a transfer occurred, name the party to whom it was delivered, and the country of production, but may find it impossible to identify where consumption occurred, or the Government to which consumption tax is rightly payable.

> "TAX EFFORT IN AN E-COMMERCE ENVIRONMENT SHOULD FOCUS ON END PRODUCTS USING INFORMATION, RATHER THAN ON THE TRANSFER THAT FACILITATES INFORMATION USEAGE."

The problem of imposing consumption tax on electronic information transfers comes increasingly, therefore, to resemble the difficulties IRD faced in trying to impose consumption tax on services associated with the movement of financial capital. Financial services were ultimately declared GST-exempt because it became apparent that compliance costs would be significantly larger than the net value of the tax collected.

In this context, transfers of financial capital are now regarded as intended merely to facilitate the creation of value as a result of its ultimate productive application. The same consideration applies equally to information. The cost of an electronic information transfer is insignificant. The cost and effort of running a fair consumption tax system for electronic information transfers may well exceed the value of the service provided.

The real value of the transaction lies not in the transfer process, but in the potential value of the information transferred, after the recipient makes constructive use of it. That value is best captured by the tax system once it has been incorporated into other goods and services that are more easily measured and monitored by the authorities for taxation purposes.

The ultimate taxable benefits of information come from the value that it adds to the end products, rather than the role of the messenger enabling the transfer. It is the consumption of those end-products that consumption tax is typically designed to capture. Tax effort in an e-commerce environment should focus on end products using information, rather than on the transfer that facilitates information useage.

New Zealand policy makers have an opportunity to address these issues not just as a means of securing revenue, but simultaneously to establish a set of incentives that will encourage industry development in an area of demonstrable natural advantage.

Tax systems should be simple, transparent, easy to implement, and they should minimise burdensome record keeping and costs for all parties. That was the original aim of the New Zealand Government when it introduced the Goods and Services Tax. A choice has to be made in finalising the GST system for electronic information transfers.

We can have a system that encourages our ISPs to export services and that attracts foreign ISPs to locate in this country. Or we can have a system that encourages our ISPs to locate overseas and that assists foreign-based ISPs to capture the business in New Zealand.

The taxable value of the transfer process per transaction will decline steadily over time as telecommunications costs continue to fall. The pay-off for New Zealand lies in encouraging maximum international business to be done through this country.

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1 Howell, Bronwyn. (2001). "Taxation Treatment of Information Service Provision", NZISCR Working Paper http://www.iscr.org.nz/research

2 Issue 1, June 2000.

OPEN TO ENTERPRISE

Opening a business in Austria takes entrepreneurs at least 154 business days, costs US$11,612 and involves 12 separate procedures, according to an international study on the regulatory requirements for entry of new firms.

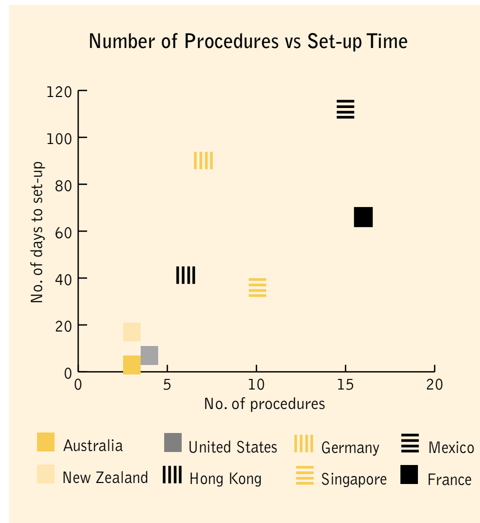
The Harvard University study[1] also examined the motivation of governments in regulating the start-up of new companies. The results suggest that not all governments act in the public's interest.

The study, which gathered data from 75 countries, defined a procedure as a legally-required activity completed outside of the firm. Canada puts in place the least barriers – just two – while Bolivia, at 20, has the most. The average country has around 10 steps.

Most procedures are to determine the applicant's suitability to run a company, rather than to ensure it will meet labour, health, environmental or tax requirements. Countries have very different regulation requirements. Columbia requires every firm, regardless of whether or not it plays music, to get a permit to "play music in public". A French company founder must provide a certificate of his or her marital status.

The authors identified three possible motivations for why governments regulate.

The "Helping Hand" theory is that governments aim to increase the welfare of society and so put restrictions on companies to encourage them to act in the interests of consumers.



The "Tollbooth" theory suggests that regulation creates opportunities for government agents at each procedure to charge a toll, thus regulation is in the interests of bureaucrats. The toll may be a legally permitted fee or a bribe.

The "Capture" theory suggests that because regulation creates barriers to entry in markets, it gives existing market participants power to charge less-competitive prices. Industry thus has an incentive to help politicians into power if they will protect their interests in return.

New Zealand has comparatively few start-up procedures: new companies must obtain approval for the company name from the Registrar of Companies, and register with the IRD and Companies Register. A new company in New Zealand can be operating after 17 days, compared with an average for all countries in the sample of 63 days.

Australia also has three procedures. While these should only take three days to complete, the study found that the legal set-up costs in Australia were more than five times greater than in New Zealand.

The study did not find any correlation between more regulation and indicators that would suggest a higher level of societal welfare, such as water quality, product standards or employee health. Nor was greater regulation associated with higher GDP. There was weak evidence that less regulation was associated with more competitive firms.

Under the "Helping Hand" theory of regulation, the consumer should reap the benefits of regulation. The study did not find a positive correlation between the number of required procedures and a number of indicators that are used to measure consumer welfare. Under the "Capture" theory, firms would get the economic rents from regulation. This was also not borne out by the study, which looked at the return on assets of publicly traded firms and at measures that indicate the extent of market competition. The study, however, did find a relationship between high levels of regulation and high levels of corruption.

The authors therefore concluded that the evidence supported the "Tollbooth" theory of regulation, as politicians and bureaucrats generally have the most to gain from regulation.

1 *Djankov, Simeon; Rafael La Porta; Florencio Lopez de Silanes; and Andrei Shleifer, The Regulation of Entry, Second Draft, August 2000.*