A Giant Problem: The Influence of the Chicago School on Australian Competition Law, Economic Dynamism and Inequality

Adam Triggs* and Andrew Leigh**

Abstract
Australia has a competition problem: there is not enough of it. Our industries are concentrated. Our markets show signs of weak competition. The way Australia’s courts, parliamentarians and regulators think about competition is partly to blame. Although it has been less influential in Australia than in the United States, the Chicago School’s views on competition have shaped our laws, policies and enforcement practices. The Chicago School views market concentration as a virtue more than a vice. The School contended that barriers to entry are negligible, market power is temporary, most mergers are good, vertical restraints and predatory pricing are either benign or efficient. The growing body of research and experience, however, shows that the Chicago School’s faith in the ability of markets to self-correct and deliver competitive outcomes was misplaced. There is a strong progressive case for repositioning how we think about competition. Focusing more on the competitive process, the structure of markets and the incentives those structures create for firms will play an important role in reducing inequality.

I Introduction
The city of Chicago is no stranger to rivalry. Its big sister, New York, likes to refer to it as ‘The Second City’, a nickname that goes back to the contest to host the 1893 World’s Fair. Even Chicago’s better-known nickname, ‘The Windy City’, is a reference to the blow-hard nature of its politicians, at least according to those from Los Angeles, Houston and Philadelphia. Chicagoans are a competitive people.

*Crawford School of Public Policy, Australian National University. The author may be contacted at adam.triggs@anu.edu.au.
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It is perhaps little wonder, then, that Chicago’s economists take a strong interest in competition, an area in which they have been profoundly influential. Before the rise of the Chicago School in the 1970s, the dominant school of economic thought on competition between firms was the Industrial Organisation School. According to this view, competition and the performance of markets were determined by the structure or organisation of an industry. An industry with only a few competitors was assumed to be less competitive than an industry with lots of competitors. This School argued that concentrated markets made it easier for cartels to form and block new entrants through predatory pricing practices and use their bargaining power against consumers, suppliers and workers. This allowed firms to hike prices, cut wages, degrade service and reduce quality while maintaining profits.

The Industrial Organisation School, traditionally associated with researchers at Harvard from the 1930s to the 1960s, viewed market concentration and mergers between firms with great suspicion. If a merger resulted in a market share that was deemed to be too high, then that merger would be blocked. If a merger resulted in what was seen to be a conflict of interest through vertical integration, such as a dominant manufacturer buying up retailers, then that merger would also be blocked, fearing it would give that firm an unfair advantage over the other retailers.

The views of the Chicago School, which emerged in the 1970s, represented a sharp divergence from the views of the Industrial Organisation School. Represented by US judges such as Richard Posner and Robert Bork, and economists such as George Stigler, Aaron Director, Harold Demsetz and Milton Friedman, the Chicago School rejected the structuralist approach of the Industrial Organisation School. The views of the Chicago School were rooted in a deep faith in the efficiency of markets and recommended minimal government intervention. If a firm tried to charge a higher price, it would be punished by the market. Competitors would quickly take its market share. If there were no competitors, then new ones would enter. Conversely, if a firm tried to charge a lower price to predatory damage their competitors, they would suffer a loss which they could never recoup since, as soon as they tried to charge higher prices later, new firms would enter. Predatory pricing without a reasonable prospect of recoupment would be irrational, so it would not take place.

The Chicago School correctly identified some flaws in the approach of the Industrial Organisation School. But it went further. For the Chicago School, market concentration was more of a virtue than a vice. In this framework, market structures were shaped by the differing efficiencies of firms over time. Accordingly, market concentration was not regarded as a sign of market power. It was rather the result of superior efficiencies. Large firms are more efficient and have greater economies of scale, meaning they can produce more with less. Big is beautiful. The fact that new entrants could only compete by obtaining similar scale was irrelevant. If the market delivered large firms, then large firms must be the efficient size and did not, therefore, represent a barrier to entry. The Industrial Organisation School tended to block mergers of firms that possessed only small market shares and did so even if they led to provable efficiencies. The Chicago School, on the other hand, was more likely to see mergers as being good and only opposed horizontal mergers that were large enough to create monopolies directly.

Unsurprisingly, there has been a search for some middle ground between the Industrial Organisation School and the Chicago School views. This came in the form of the Post-Chicago School, which emerged in the late-1980s and early-1990s. The Post-Chicago School tends to focus less on theory and more on application. This approach is characterised by a richer factual analysis of individual cases and the application of more complex rules based on strategic models.
rather than reliance on more theoretical models and per se tests,’ writes Kathryn McMahon. The Post-Chicago School emphasises the importance of strategic behaviour of firms, noting that firms do not just respond passively to structural market conditions; they actively attempt to influence those conditions through strategic behaviour.

Such views have even permeated the University of Chicago itself. In 2017, 12 decades after engineers reversed the Chicago River, the Chicago School held a summit on the threat that monopolies posed to the American economy. Such an event would have been unheard of in the last century. The Economist quipped that ‘convening a conference supporting [competition] concerns in the Windy City was like holding a symposium on sobriety in New Orleans’.

‘What has changed?’ asks The Economist, ‘The facts. The pendulum has swung heavily in favour of incumbent businesses’. The growing body of empirical evidence shows that many of the views of the Chicago School were misplaced. The Chicago School’s faith in the absolute ability of markets to self-regulate and deliver competitive outcomes has not stood the test of time.

In this article, we argue that the Chicago School has had a powerful impact on the economic thinking of Australia’s courts, legislators and regulators. It has helped shape the poor state of competition in Australia and, most alarmingly, has contributed to rising inequality. The article is structured as follows. Section II provides a stocktake of the state of competition in Australia. It shows how concentrated markets and a lack of competition are damaging the Australian economy. Section III explores the influence of the Chicago School on Australia’s courts, legislators and regulators. It explores the role that this influence has had in shaping the competitive outcomes in the Australian economy. Section IV looks at the consequences of these outcomes for rising inequality in Australia. It explores how the weakening of competition in Australia has helped increase inequality. Section V concludes by exploring what can be done to strengthen competition in Australia in the future.

II Australia’s Competition Conundrum

It is hard to think of many Australian industries these days that are not dominated by just a few behemoths. Whether it is Coles or Woolworths, Lion or Carlton, Caltex or BP, Medibank Private or BUPA, Qantas or Virgin, consumers often have limited choices when it comes to where they get their goods and services from.

This is borne out in the numbers. One standard measure of concentration judges an industry to be concentrated if the top four players control more than one-third of the market. We recently calculated this measure across 481 industries. We found that more than half of Australia’s industries were concentrated. Some sectors are particularly tightly controlled. In department stores, newspapers, banking, health insurance, supermarkets, domestic airlines, internet service providers, baby food and beer, the biggest four firms comprise more than 80% of the market.

Comparing this to the United States, things do not look much better. Australia’s markets are more concentrated than those in the United States in aggregate, particularly in some of our most important sectors. Our commercial banks, petrol retailers and liquor retailers are more than three times as concentrated as those in the US. Our supermarkets and health insurers are twice as concentrated. Our department stores, airlines, soft drink manufacturers and cardboard box makers are all significantly more concentrated. As Tim Wu argues in his book The Curse of Bigness: Antitrust in the New Gilded Age, market concentration around the world is the highest it has been in more than a century.
A cross-country analysis by the World Economic Forum asked experts to rank the ‘extent of market dominance’, with the highest ranked countries being those where corporate activity is spread among many firms. Australia comes in at 47th, placing us between Ghana and Brazil. In terms of banking, analysis of data from the World Bank finds that Australia’s banking sector is more concentrated than the Organisation for Economic Cooperation (OECD) average. A report on competition by the Grattan Institute reached more sanguine conclusions than we would be inclined to, but nonetheless found that print and broadcast media, liquor retailing, domestic aviation and internet platforms were more concentrated in Australia than in other countries.

There are two main reasons for this increase in concentration. The first reason is that Australia is seeing a decline in the rate at which new businesses are being created, falling from 15% in 2005 to 9% in 2014. The second reason is that the number of mergers and acquisitions has increased significantly. From 1992 to 2018, the annual number of mergers and acquisitions in Australia roughly quintupled, from 394 to 1,909.

Does this mean competition is lower? If you want to know whether firms are worried about competition, don’t listen to what they say. Listen to what they don’t say. A study by AXA Investment Managers Rosenberg Equities trawled through thousands of annual reports by US companies. The researchers found that the use of the word ‘competition’ in those reports declined by three-quarters over the period from 2000 to 2017.

Another way of assessing competition is to look at the mark-ups being charged by firms. Jan De Loecker from Princeton and Jan Eeckhout from University College London extracted data from the financial statements of over 70,000 firms in 134 countries and analysed the evolution of mark-ups over the last four decades. In Australia, they found that the average prices charged by large listed firms were close to the marginal cost of production in 1980 and hovered around that point until the late 1990s. By the early 2000s, the average prices charged by listed firms were 40% above the marginal cost of production. By 2010, they were around 50% above marginal cost. By 2016, they were nearly 60% above marginal cost.

There is growing evidence that market concentration may be suppressing investment. Germán Gutiérrez and Thomas Philippon from NYU, for example, found that industries with more concentration and more common ownership invest less, even after controlling for current market conditions. They conclude that 80% of aggregate under-investment since 2000 can be explained by less competitive markets and increased ownership of stock by institutional investors. Admittedly, these US findings may not necessarily be applicable to Australia. But as Paul Krugman and Larry Summers point out, if market power was increasing, we would expect to see high corporate profits but low rates of investment, despite relatively low interest rates and high stock prices. ‘This,’ Larry Summers points out, ‘is exactly what we have seen in recent years!’ The same pattern holds in Australia.

Another critical challenge facing many economies is weak wage growth. Could weak competition be part of this story? Wages are fundamentally driven by the competition between firms for workers. Less competition means lower wages. This can happen directly, as was the case in 2010 when Apple, Google, Intel, Intuit and Pixar were taken to court by the Department of Justice for secretly agreeing not to hire each other’s workers to avoid bidding up wages. It was a cosy arrangement for those companies, but not so good for their workers who, despite years of education and skills that should have been in high demand, were struggling to get a pay rise.

At the macro level, David Autor and colleagues analysed panel data from the US Economic Census from 1982 to 2016. They found that industries in which market concentration had risen the
most also saw the largest declines in the labour share. The possibility that excessive market concentration could serve as a drag on growth has even attracted the attention of the world’s central bankers, who considered this very issue at their annual gathering in Jackson Hole, Wyoming. ‘A few years ago, questions of monopoly power were studied by specialists in a very technical way, without linking them to the broader issues that animate economic policy,’ said Jason Furman, an economist at Harvard and former chief economist in the Obama White House. ‘In the last few years, there’s been an explosion of research that breaks down those walls.’

The classic Chicago School response would be to dismiss these concerns given the increased efficiencies that flow from having larger businesses. Yet the evidence points in the opposite direction. A British study by Stephen Nickell found that a 25% increase in market concentration leads to a 1% fall in productivity. Bruce Blonigen at the University of Oregon and Justin Pierce at the US Federal Reserve used detailed firm-level data to study the impact of mergers and acquisitions on productivity and market power across all US manufacturing industries. They found that mergers were associated with increases in average mark-ups, but did little to boost productivity. Blonigen and Pierce also found little evidence in favour of other claimed efficiency gains from mergers, such as reallocation of activity across plants or scale efficiencies in non-productive units of the firm.

The other Chicago School argument often used to justify concentrated markets is that barriers to entry are low and easily surmountable. The Chicago School’s central contention is that if a firm can exploit monopoly profits, then more firms will quickly enter that market. We can test this in Australia by seeing whether the industries which have enjoyed the largest increase in profits have also seen an increase in new entrants. Across 15 industries, one can look at the correlation between percentage change in profits in 2008–09 and the percentage change in the number of new entrants over the next 8 years.

Across the economy, profits grew 13% in real terms, while the number of firms grew by 5%. At an industry level, there was indeed a modest positive correlation (0.29) between profit growth and the number of firms. But the results are decidedly mixed. In mining, for example, profits increased 42%. Yet, the number of firms operating in the industry remained unchanged. The largest increase in profits occurred in the professional services industry, where profits rose 62%, nearly five times more than average. Yet the number of firms rose only 9%, less than twice the average growth rate. It is possible that this reflects licensing laws and other barriers to entry, which prevent new entrants from capitalising on the higher profits.

The Post-Chicago literature has emphasised the prevalence of strategic barriers to entry and the chilling effect these can have on competition and potential new entrants. Sandeep Vaheesan details evidence in the US that ‘leading firms in the airline, coffee, oil, shipping, sugar, telecommunications, and tobacco industries, among others, have used predatory pricing to preserve or enhance their market power’. Lina Khan gives similar warnings about Amazon. ‘Although Amazon has clocked staggering growth,’ warns Khan, ‘it generates meager profits, choosing to price below-cost and expand widely instead’. Khan notes that ‘[i]n addition to being a retailer, it is now a marketing platform, a delivery and logistics network, a payment service, a credit lender, an auction house, a major book publisher, a producer of television and films, a fashion designer, a hardware manufacturer, and a leading host of cloud server space’.

This may also be bad news for start-ups. The Economist recently reported that around the FAANGs—Facebook, Amazon, Apple, Netflix and Google—there is now a ‘kill zone’, in which
companies are either acquired or quashed. Mike Driscoll, a partner at Data Collective, says that in recent years, technology conferences ‘send shock waves of fear through entrepreneurs… Venture capitalists attend to see which of their companies are going to get killed next’ he said.\textsuperscript{43} This has made some venture capitalists more reluctant to invest in customer-focused start-ups.

Traditional barriers to entry are just as important. To create a search engine that can compete with Google, a competing firm does not just need a better algorithm, it also needs a set of servers large enough to store some version of the internet. There are only a handful of companies in the world that have the resources to do this. The same phenomenon has occurred in advertising. In both Australia and the US, spending on digital advertising exceeds combined spending on print, radio and television advertising. Together, Google and Facebook have 59\% of the digital advertising market in the US and 68\% in Australia.\textsuperscript{44} The number of independent advertising technology firms has declined, and venture capital investors are increasingly reluctant to back advertising technology start-ups.\textsuperscript{45}

It should be noted that not all are convinced by Khan’s arguments about the monopoly power of the Tech Titans, with one critique arguing that they are based on misplaced nostalgia for a bygone era when the field of antitrust ‘had no clear objectives and cases were decided on impressionistic notions of “fairness”’.\textsuperscript{46} There remains a lively debate about the extent to which technology firms with large market shares today can be confident about their futures. Google chief economist Hal Varian notes that large technology firms do not operate in silos, but have competed against one another.\textsuperscript{47} Varian gives the example of the digital assistant market, where there has been significant competition between Google Assistant and Amazon Alexa. He also points out that the market for commercial search (which is where the revenue is highest) is competitive within specific categories, such as hotels, airlines and online shopping.

More generally, Robert Akerlof, Richard Holden and Luis Rayo argue that in the presence of network externalities, the position of large incumbents can be more fragile than it might initially appear.\textsuperscript{48} They point to the historical example of Internet Explorer displacing Netscape in the 1990s ‘browser wars’ and argue that the potential entry of a rival has led dominant firms such as Uber, Amazon Web Services and Google to keep prices low. Similarly, it is possible that Facebook’s launch of its own digital currency will challenge the market power of large financial institutions, benefiting consumers.

There are risks in both directions. Those who take a more sanguine perspective about market concentration point to the example of US antitrust action against vertically integrated grocery chain A&P in the 1940s, which likely led to an increase in food prices. But if this view turns out to be wrong, a lax approach to monopoly power may end up allowing them to lock in their positions. In an article titled ‘The Market for Bigness: Economic Power and Competition Agencies’ Duty to Curtail It’, Adi Ayal warns of the risk that these firms parlay their market share into political influence. Through an ‘influence effect’, firms use their scale and scope economies to procure political influence, further tipping the scales against potential rivals.\textsuperscript{49} One dystopian thought experiment is to imagine if technology companies, rather than being at loggerheads with President Donald Trump, had chosen to actively collaborate with him in achieving his political goals—in exchange for protection from antitrust actions affecting their businesses.

\textbf{A Anti-Competitive Conduct}

The weakening of competition and rise in market power in Australia can be seen in the behaviour of firms. One such example is the long payment terms that have been imposed on suppliers in
recent years by companies such as BHP, Procter & Gamble, Mars, Kellogg, Heinz and Woolworths. According to one analysis, large Australian companies, particularly those in concentrated markets, were almost 20% slower in paying their suppliers than small companies.

Another such example is in farming. In 2016, Murray Goulburn retrospectively cut the price it paid to dairy farmers and then asked them to pay back the difference. Farming is a relatively competitive sector, but farmers are squeezed by their suppliers and customers: purchasing pesticides, fertilizers and seeds from just a few sellers, and then finding life tough as they sell their produce to a small number of processors and supermarket chains.

One does not have to look far these days to see anti-competitive conduct in the Australian economy. Whether it is telcos telling tall tales or cartels in car parts, problems abound. ‘There is clearly no shortage of work for the ACCC’ said Rod Sims, Chairman of the ACCC. ‘[Many] well-known and respected major Australian companies . . . have admitted, or been found, to have breached our competition and consumer laws. These same companies regularly proclaim they put their customers first’ he said. Indeed, we can see some of the changes that have been made to Australia’s competition and consumer laws over recent years—civil fines for unconscionable conduct, the criminalisation of cartels, higher penalties for breaches of consumer protection provisions—as a reaction to the growth of market power among Australia’s behemoths.

There have also been problems created by the poor regulation of privatised monopolies. Where a monopoly asset is placed in private hands, our economics textbooks predict that prices will rise well above the marginal cost of production that should govern pricing in a competitive market. In the absence of appropriate regulation or oversight, we should not be surprised if this is exactly how new monopoly owners behave. Whether it is a port or an airport, it is important that governments ensure that the gains to taxpayers from selling an asset are not offset by the losses to consumers from higher prices.

B Anti-Consumer Conduct

Australia’s weakening competition can also be seen in how firms treat their customers. In 2008, the ACCC received about 34,000 complaints of misleading conduct. In 2016, it was closer to 60,000. More than 155,000 scams were reported in 2016, costing Australians $83.6 million a year. The list of companies that have been reprimanded by the ACCC or the Federal Court over the past few years reads like the ‘who’s who’ of the top end of town.

We’ve had Kimberly-Clark sell Australians flushable wipes that are about as flushable as a bathmat. We’ve had Nurofen sell us a variety of different pain medications where the only difference was the colour of the box. We’ve had Heinz market fruit and vegetable products to children with six times more sugar than your average apple. We’ve had Dulux sell us cooling paint that doesn’t cool, Uncle Toby’s sell us protein oats that don’t contain protein and Woolworths sell us deep fryers with handles that only sometimes stay attached. Consumer breaches can also harm competitors, as when Coles was found to have wrongly claimed that its bread was ‘Freshly Baked In-Store’: thereby harming smaller bakeries that really did bake their loaves on the premises.

III From Chicago to Canberra

Australia faces a host of competition challenges. As the preceding section suggests, there are a variety of factors that have contributed to this outcome. But one of those factors is how our courts, legislators and regulators think about competition issues.
Canberra is home to the High Court, Federal Parliament and the national office of the Australian Competition and Consumer Commission. All three appear to have been influenced by the Chicago School to differing degrees and at different times. It can be difficult to identify with precision how much influence a particular school of thought has on any individual or institution. But the influence of the Chicago School on Australia can be observed directly when our judges, for example, reference Chicago School jurists and economists.

Australia’s courts, it must be said, have been much less influenced by the Chicago School than in the United States. Nonetheless, the significant influence of the Chicago School on Australia’s courts has been documented by many thoughtful legal scholars, including Kathryn McMahon, Stephen Corones, Alex Bruce and David Round. The potential for such influence is not surprising. At its core, the Competition and Consumer Act embodies economic concepts which are prone to change as circumstances and economic thinking change over time. As former Attorney-General Lionel Murphy noted in 1973: ‘Legislation of this kind is concerned with economic considerations. There is a limit to the extent to which such considerations can be treated in legislation as legal concepts capable of being expressed with absolute precision.’ The stated object of the Competition and Consumer Act to ‘enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection’ similarly leaves much scope for differing interpretations.

A Vertical Restraints

One area of Chicago School influence is in vertical restraints. An example of a vertical restraint is where a manufacturer might limit what its distributors can do with its product, including the prices they can charge, through licensing or price restrictions.

The Industrial Organisation School sees such restraints as being problematic because they allow firms to leverage power from one market to another. For example, a powerful manufacturer might impose its market power at the retail level, potentially killing off competition and spreading their influence.

The Chicago School, in contrast, sees any attempts to regulate vertical restraints as misconceived, arguing that such restraints can improve efficiency by allowing seamless supply chains from manufacturer to distributor, from distributor to retailer and from retailer to consumer. These restraints are generally explicable on the basis of efficiencies (such as by preventing free-riding) and are therefore good for consumer welfare.

The US Supreme Court’s decision in Sylvania adopted the Chicagoan view and approached vertical restraints from the perspective of the manufacturer. In the Australian case of Melway Publishing Pty Ltd v Robert Hicks Pty Ltd t/as Auto Fashions Australia, the High Court then adopted the view of the Supreme Court in Sylvania which, indirectly, meant adopting the views of the Chicago School.

In that case, Melway published and distributed street directories through its own selective distribution system and refused to supply its street directories to a company called Auto Fashions after it discovered that Auto Fashions was distributing the street directories itself, competing with Melway’s own distribution channels. Consistent with American authorities, the majority found that there was no problem with Melway blocking supply to Auto Fashions. They concluded that limiting intra-brand competition, such as limiting the competition between Melway and Auto Fashions in distributing Melway’s street directories, could help competition rather than harm it, given the efficiencies that could be generated.
B Predatory Pricing

Another example arises in the case of predatory pricing, where a firm deliberately charges a price that is below-cost to push its competitors out of the market and scare off any new competitors from coming in. The challenge for our courts is how to prove it.

The approach taken by the Industrial Organisation School is to first look at the market and determine whether a firm could make more profit by temporarily pricing low in order to drive rivals out of business. They saw it as quite conceivable that there might be markets where this was an attractive strategy for a large incumbent. The second part of the test was whether a firm was setting prices below its average variable costs. If both standards were met, then this was presented as evidence of predatory pricing.76

The Chicago School takes a different approach. The Chicago School sees predatory pricing as being fundamentally irrational.77 If a firm wants to charge below cost, then so be it. That is great news for consumers who get ultra-cheap goods and services. Even if a firm does manage to kill off its competitors (which the Chicago School thinks is unlikely since a firm cannot price below cost forever), as soon as it tries to increase prices in the future to recoup its losses, new firms will enter and prevent it from doing so.

The Post-Chicago School would say that this is all too simple. They would argue that this ignores the strategic ways in which firms try to shape markets in their own favour. A firm engaging in predatory pricing or over-investing in production capacity may, for example, send a warning shot to new entrants: ‘enter this market’ they say ‘and we’ll instantly undercut your prices and ramp up production’. This, they argue, can have a chilling effect on competition and should therefore be outlawed.

Historically, the approach of Australia’s courts was more in line with the Industrial Organisation approach. A typical case is the 1992 decision of Eastern Express Pty Ltd v General Newspapers Pty Ltd,78 in which the majority of the High Court opted for an approach of assessing the firm’s costs and then determining whether they were pricing below it.79 Like the Industrial Organisation School, they were open to the prospect that there might be plenty of markets in which recoupment was possible.

But in the years that followed, the High Court’s approach shifted in favour of the Chicago School. Many in the Chicago School found it difficult to see how there could be markets where predatory pricing would be a profitable strategy. The ‘recoupment test’ involved asking whether or not the firm that was allegedly pricing below cost would be able to charge higher prices in the future, thus recouping its lost profits. For those who were faithful to the Chicago School, however, the answer was almost always ‘no’ since the Chicago School tends to believe that barriers to entry are low such that new entrants can quickly emerge.80

This shift in thinking is particularly evident in the 2003 decision of Boral Besser Masonry Ltd v Australian Competition and Consumer Commission which involved the supply of concrete masonry products—perhaps not the easiest industry for a new competitor to break into.81 Boral involved a price war in the supply of such products in Melbourne. The war got so severe that the ACCC took Boral to court. It alleged that Boral was supplying concrete masonry products at below cost and was ramping up production with the purpose of driving its competitors out of the market.82

In the first instance, Heerey J rejected precedent and adopted the recoupment test put forward by the Chicago School.83 Kathryn McMahon called this ‘a deference to the self-regulating capabilities of the market’ and a clear adoption of the Chicago School’s views.84 On appeal, Finkelstein J discussed the recoupment standard that had been adopted by Heerey J and noted its direct origins to the Chicago School way of thinking.85
Finkelstein J recognised that the practical implications of adopting the standard may frustrate the objects of the provision. Kathryn McMahon argued that ‘[r]ecoupment should have been identified as a particularly Chicagoan approach that rejects cost standards as the sole determinant of predatory pricing conduct’ suggesting there was a lack of transparency in the Court’s decision. Garth Campbell, from Wentworth Chambers, noted that ‘the requirement for recoupment in [the US case of] Brooke Group implicitly recognised the Chicago School’s theories, as it did not consider the other less obvious motivations for predatory pricing recognised by the Post-Chicago School… This decision was referred to with approval by the Australian High Court in *Boral*’.88

Others have been more direct. McHugh J, in the High Court, has on multiple instances directly cited the works of Chicago School economists in His Honour’s judgments. Citing Richard Posner, one of the leading voices of the Chicago School, McHugh J in the *Boral* case puts forward the Chicago School’s view of the duties of the dominant market player, saying that ‘even a firm with a substantial degree of market power has no general duty to help its competitors, whether by holding a price umbrella over their heads or by otherwise pulling its competitive punches’.90

Specifically, McHugh J cited Posner to support his preference for the recoupment standard over pricing or cost standards for predatory pricing. ‘In my view’ he said ‘what is required is not a bright line rule about costs but a more sophisticated analysis of the firm, its conduct, the firm’s competitors, and the structure of the market not only at the time in which the firm has engaged in conduct allegedly in breach of the Act but also before and after that conduct’.91

The Chicago School’s view on recoupment has not been universally accepted. Although it has been highly influential in the US, it has been rejected by courts in Europe, albeit controversially. Similarly, the Australian Parliament swept away recoupment entirely, via a 2008 amendment (repealed in 2017) which stated that a firm could breach predatory pricing laws even if it was unable to recoup its losses from supplying at below cost.

The High Court has considered economic efficiency arguments, critical to the Chicago School’s reasoning on market concentration, regarding misuse of market power provisions (of which predatory pricing is one example). Before the 2017 ‘effects test’ amendments, these provisions prohibited a firm from taking advantage of (or using) its substantial market power for the purpose of damaging a competitor. The High Court has, however, held that a firm which undertakes some act which damages its competitor is not in breach of this provision if its act was for the primary purpose of improving efficiency (often dubbed the ‘legitimate business rationale’ defence). It is unclear how efficiency considerations will operate given the effects test amendments.

C Barriers to Entry

Another critical area of the Chicago School’s influence in Australian courts is regarding barriers to entry. The economic concept of barriers to entry is critical. It influences multiple provisions of the Act. If barriers to entry are perceived to be low, then mergers are more likely to be approved on the grounds that the risk of anti-competitive conduct in a more concentrated market structure is reduced by the prospect of new entry. Barriers and market contestability help courts decide whether a firm has substantial market power—and therefore can potentially misuse that power. Additionally, barriers to entry are relevant to determining whether horizontal and vertical agreements have anti-competitive effects.
The Chicago School tends to view barriers to entry as being low. Even in markets with substantial economies of scale, such as supermarkets where Coles and Woolworths own hundreds of stores that are vertically integrated from retail into wholesale, distribution and even manufacturing (in the case of private label products), the Chicago School views this as simply being the scale required to compete and therefore does not constitute a barrier to entry.

This is particularly the case for ‘strategic barriers to entry’, where firms erect their own barriers to strategically deter new entrants. These include predatory pricing policies, investment in excess capacity and locking in long-term contracts—all tactics with the objective of scaring off potential competitors. The Post-Chicago School, in particular, stresses the importance of these strategic barriers, barriers which are discounted by the Chicago School given its trust in the ability of markets to punish those who try it.

In the Boral case, the High Court expressly considered this Post-Chicago School literature. But ultimately, it deferred to the approach of the Chicago School. The majority concluded that where structural barriers to entry are low, it is not legitimate for a court to base a finding of substantial market power simply upon incidents of abuse of power, or strategic entry-deterring tactics in that market. In short, they concluded that strategic barriers to entry, alone, were not enough.

Justice Kirby disagreed, arguing that ‘[i]t is precisely in the context of a market where such structural barriers are not particularly high, that an incumbent corporation which has the capacity to do so, would have a greater incentive to invest in building up a predatory reputation in order to deter competitive conduct or entry’. He went on to say that ‘the strengthening of the predatory reputation of [Boral] had a tendency to increase the concentration of the market and to chill the competitive conduct of rivals, including the entry of potential new competitors. Such conduct invariably harms consumers’.

D Legislation and the Regulator

The influence of the Chicago School is not limited to our courts. A body of research similarly suggests that the Chicago School has been influential in Australia’s legislation, particularly the laws governing mergers and acquisitions.

Surveying Australian legislative history, Maxine Rich concludes that Chicago School thinking has played a significant role in shaping the merger laws, albeit less than in the United States. Stephen Corones similarly concluded that ‘Australia’s current merger law reflects Chicago School thinking according to which mergers should generally be allowed to the point of duopoly in the name of efficiency’.

Australia’s merger laws are contained primarily in s 50 of the Competition and Consumer Act. After the dismissal of the Whitlam Government, the Fraser Government reformed the then Trade Practices Act. The Fraser Government was much more sympathetic to Chicago arguments, particularly around the perceived need for Australian firms to achieve scale to compete internationally.

Under the existing Act, a merger would be opposed if it resulted in a ‘substantial lessening of competition’. For the Fraser Government, this threshold was considered to be too onerous. So as to encourage more mergers and acquisitions, the Fraser Government changed the Act. Now, a merger would only be opposed if it resulted in or substantially strengthened a ‘position to control or dominate a market’.

The Merger Guidelines at the time of the then Trade Practices Commission (now the ACCC) also adopted the Chicago School’s approach. Rich notes that ‘under its Merger Guidelines, the
Trade Practices Commission has adopted a general formulation of “market” which applies both to product and geographic market definition. It largely reflects the price-based analysis advocated by Chicago School proponent, Judge Posner.\textsuperscript{105}

The 1999 version of the Merger Guidelines had a similarly Chicagoan feel. The first substantive paragraph of the guidelines referred to the important role of mergers in allowing ‘firms to achieve efficiencies such as economies of scale, synergies and risk spreading’.\textsuperscript{106}

The ACCC’s most recent guidelines have deviated significantly. The 2008 guidelines outline what the ACCC considers to be the primary change to the guidelines since the previous version, noting that the new guidelines have ‘an increased emphasis on the competitive theories of harm and the effect of constraints, which facilitates a more integrated analysis’.\textsuperscript{107} In regards to the ACCC’s merger authorisations process, the current guidelines acknowledge that efficiencies may constitute a public benefit, but emphasise that they need to be sure that this ‘outweighs the public detriment from the substantial lessening of competition’.\textsuperscript{108}

The ACCC’s attitudes on mergers has shifted in other ways, too. In 2018, ACCC Chairman Rod Sims addressed the Law Council about mergers, acknowledging that the ACCC has had a historically poor track record of opposing some mergers and the need to change approach. Sims noted the ACCC’s increased use of s 155 notices to remedy this—mandatory information gathering powers to command information, documents and oral evidence in merger assessments.\textsuperscript{109} In this sense, the shift in the ACCC’s approach is perhaps less about their economic assessment than about their ability to gather sufficient evidence to be ready for litigation against well-resourced opponents.

Another sign of the evolution of the competition watchdog is a 2018 ACCC report recommending a number of actions to help reduce electricity prices. These include a cap on mergers which prevents any merger that resulted in a market share of 20\% or more in electricity generation. This suggests that the ACCC sees a significant link between market concentration, market power and weakening competition.\textsuperscript{110}

Rich similarly notes that Australia’s legislative approach to mergers and acquisitions has shifted.\textsuperscript{111} Following the report of the Cooney Committee, the Keating Government in 1993 restored the original ‘substantial lessening of competition’ test. For some sectors, the change came too late. In 2002, Allan Fels, then Chairman of the ACCC, criticised the Fraser Government’s dominance test for failing ‘to prevent a significant category of mergers that were likely to substantially lessen competition’ noting ‘criticisms that the dominance test had failed to deliver the gains in efficiency and international competitiveness that would supposedly be achieved by allowing more mergers’.\textsuperscript{112}

Fels noted a series of mergers that went through under the dominance test which would not have been allowed under the ‘substantial lessening of competition’ test. These included the mergers between Coles and Myer, News Ltd and Herald & Weekly Times and Ansett Airlines and East West Airlines.\textsuperscript{113} Each of these industries now rank as some of Australia’s most concentrated markets.

The most recent review of Australia’s competition laws, policies and institutions was the Harper Review. The report does not explicitly draw on Chicagoan thinking, although it does discuss the trade-off between preventing anti-competitive conduct and promoting efficiencies.\textsuperscript{114} The Harper Review’s discussion of the effects test similarly considered enhanced efficiency to be a form of improved competition in itself.\textsuperscript{115}
IV Inflaming Inequality: The Cost of Constrained Competition

The challenges explored in Section II—sluggish wage growth, a declining labour share, increased mark-ups and less competition for workers—all exacerbate inequality. Over the period 1975–2016, real earnings in Australia rose by 24% at the 10th percentile, 46% at the median and 74% at the 90th percentile. Over this four decade period, wage growth was three times faster for the top tenth than the bottom tenth of earners.

Since 2012, the problem of stagnant wages has come to affect many across the economy. Despite solid growth in profits and productivity, real wage growth for the typical Australian worker has been close to zero. This shows up in the share of national income going to workers in the form of wages, salaries and superannuation benefits. Since the late-1970s, the labour share has dropped by 7–10 percentage points (depending on precisely how it is measured).

A growing body of evidence suggests that the rise in inequality and the fall in competition are not merely coincidental. Sean Ennis, Pedro Gonzaga and Chris Pike analyse data from eight economies—Canada, France, Germany, Korea, Japan, Spain, the United Kingdom and the United States. On average, they found that market power increases the wealth of the richest decile by up to one-fifth. Our own research, co-authored with Joshua Gans and Martin Schmalz, takes a similar approach, but instead studies a single country—the United States—over nearly three decades. We find that corporate equity has become even more skewed relative to consumption. This has exacerbated the extent to which increased mark-ups raise inequality.

Research by John Creedy and Robert Dixon, using Australian data, found that monopoly power has a larger impact on lower income groups and increases inequality. William Comanor and Robert Smiley reached a similar conclusion in the United States, finding that possibly one-half of existing wealth holdings by the richest few per cent of American households was due to monopoly gains. Surveying the literature in both developed and developing nations, Begazo Gomez and Anna Nyman from the World Bank similarly concluded that a lack of competition tends to hurt the poorest households the most.

In Australia, Paul Frijters and Gigi Foster analyse how the richest 200 made their money. They conclude that just five had become rich primarily by inventing a new product or service. Far more commonly, the most affluent operated in industries with limited competition or with significant reliance on government decisions. One analysis from the 1990s looked at the industries in which the rich-listers made their fortunes. It concluded that about one-quarter grew wealthy in an industry that was uncompetitive at the time. Since then, the problem may have become worse. As one commentator noted of the 2012 BRW rich list: ‘There is a dearth of new, young and entrepreneurial people’.

V Conclusion

In many sectors, Australia’s industries are excessively concentrated. Anti-competitive conduct is rife. Our consumers are treated poorly. Many markets show signs of weak competition. There has been a massive increase in mark-ups among large listed firms over the past two decades.

Much of the popular analysis of these trends focuses on technological changes. Commentators rightly debate the potential for the internet and mobile computing to provide the FAANGs with a far greater degree of market dominance than their old economy forebears.

But heavily concentrated markets are also a reminder of the need to ensure that the correct philosophy undergirds Australian competition policy. Although it was less influential in Australia...
than in the United States, the Chicago School’s views on competition have influenced our laws and policies. The Chicago School saw market concentration as a virtue more than a vice. In its view, barriers to entry are negligible, market power tends to be temporary, most mergers are good, vertical restraints and predatory pricing are either benign or efficient.

A growing body of empirical evidence shows that these views were misplaced. The Chicago School is, itself, beginning to backtrack. A blind faith in the absolute ability of markets to self-regulate and deliver competitive outcomes has not stood the test of time. Competitive markets should be the objective, not our assumption.

There is a strong case for repositioning how Australia thinks about competition. Ensuring that we do not adopt an overly permissive approach to mergers. Taking a more circumspect approach to claims of efficiency when considering anti-competitive conduct. Giving the regulator the investigatory powers it needs. Making sure that penalties are not treated as just a cost of doing business. Considering the impact of anti-competitive conduct on innovation. Recognising that unchecked market power can harm workers as well as consumers.

Inequality is not simply a function of taxation and government programs, important as they are. Focusing more on the competitive process, the structure of markets and the incentives those structures create for firms will play an important role in reducing inequality. The functioning of our markets, the adequacy of our regulators and institutions, the structure of firms and the interactions between them shape Australian egalitarianism. Getting them right will be critical to the future living standards of Australians.

Notes

4. Ibid.
5. Ibid.
6. Ibid.
8. Khan (n 3) 734.
10. ‘Herrera Anchustegui, Ignacio’. (2015). Competition Law through an Ordoliberal Lens. *Oslo Law Review* 2. 139.: European competition law has its own distinct intellectual origins, including the Ordoliberal School which emphasises the importance of checks on monopolies as a means of ensuring that powerful economic forces do not adversely affect the health of the democracy.
13. Corones (n 2) 27–8.
15. Ibid.
18. Ibid 394.
21. Leigh and Triggs (n 17) 393.
23. Sasan Bakhtiari, ‘Entrepreneurship Dynamics in Australia: Lessons from Micro-Data’ (2019) 95(308) *Economic Record* 114, 122 (note that while the text states that the 9% statistic is for 2015, the author has clarified with us that the statistic is actually for 2014, which is consistent with his figure 5).
34. Leigh and Triggs (n 17) 401.
38. Note that this approach is inherently biased in favour of finding a positive relationship between the change in profits and the change in the number of firms. To see this, suppose that an entirely new sub-industry emerges. This sub-industry would both increase profits and the number of firms within its industry.
41. Khan (n 3) 710.
42. Ibid 713.
53. Leigh and Triggs (n 17) 402–9.
55. This is a long-held concern for the Labor party: Murray Goot, ‘Labor, Government Business Enterprises and Competition Policy’ (2010) 98 Labour History 77, 77.
58. Ibid 9.
59. Ibid; ‘Pental to Pay $700,000 in Penalties for “Flushable” Wipes Claims’ (Media Release No 64/18, 12 April 2018).
60. Ibid; ‘Empowering Consumers Against Companies’ (Media Release No 142/18, 31 July 2018).
61. Ibid.
62. Ibid; ACCC, ‘Dulux to Pay $400,000 for Misleading Cooling Paint Claims’ (Media Release No 201/16, 3 November 2016).
64. Ibid; ACCC, ‘Woolworths Misled Consumers Over Product Safety Hazards—Ordered to Pay Over $3 million in Penalties’ (Media Release No 7/16, 5 February 2016).
65. Ibid; ACCC, ‘Coles to Pay $2.5m for Misleading “Baked Today” and “Freshly Baked In-Store” Bread Promotion’ (Media Release No 58/15, 10 April 2015).
66. The High Court continues to approach competition law issues using the structure-conduct-performance approach that had its origins in the Industrial Organisation School dating back to the Trade Practices Tribunal’s landmark decision in Re Queensland Co-operative Milling Association Ltd (1976) 25 FLR 169 (Woodward J, Member Shipton and Brunt). The Dawson Committee in the early 2000s similarly rejected the idea of including an economic efficiency test which, consistent with the Chicagoan approach, would allow more mergers to be approved: Corones (n 2) 39.
67. McMahon (n 12).
68. Corones (n 2).
69. Alex Bruce, Australian Competition Law (LexisNexis Butterworths, 2nd ed, 2013).
74. Continental TV Inc v GTE Sylvania Inc (1977) 433 US 36, 55–6 (‘Sylvania’).
75. Melway Publishing Pty Ltd v Robert Hicks Pty Ltd (2001) 205 CLR 1, 14 [20].
77. Frank H Easterbrook, ‘Predatory strategies and counterstrategies’ (1981) 48(2) University of Chicago Law Review 263, 336–7. Note however that the Chicago School is not monolithic on this point. For example, Richard Posner argues that predatory pricing can exist but the test should be whether an incumbent was pricing below marginal cost with intent to harm a rival: Richard A Posner, Antitrust Law (University of Chicago Press, 2nd ed, 2009) 216.
79. Ibid [383].
80. Khan (n 3) 744.
84. McMahon (n 12) 820.
86. Ibid 405.
87. McMahon (n 12) 820.
89. See, for example, CSR Limited v Eddy (2005) 226 CLR 1, 40 [95] (McHugh J); Carson v John Fairfax & Sons Ltd & Slee (1993) 178 CLR 44 [18] of McHugh J’s dissenting judgment.
94. This provision was originally inserted as Trade Practices Act 1974 (Cth) s 46(1AAA) by Trade Practices Legislation Amendment Act 2008 (Cth) sch 2 item 1A but was later repealed and substituted by Competition and Consumer Amendment (Misuse of Market Power) Act 2017 (Cth) s 1.
95. Competition and Consumer Act 2010 (Cth) s 46.
96. Corones (n 2) 39.
98. Corones (n 2) 114–17.
99. Ibid.
101. Ibid.
103. Corones (n 2) 114.
108. Ibid 49 [7.66].
110. Australian Competition and Consumer Commission, Restoring Electricity Affordability and Australia’s Competitive Advantage (Final Report, June 2018) [viii].
111. Rich (n 102) 121–2.
112. Fels (n 104) 8.
113. Ibid 10.
115. Ibid 61.


117. Andrew Stewart, Jim Stanford and Tess Hardy (eds), The Wages Crisis in Australia: What It Is and What to Do About It (University of Adelaide Press, 2018) 22.

118. Labour compensation as a share of GDP has fallen from over 55% in the 1970s to a historic low of 46.5% in 2017, labour compensation as a share of factor income (which excludes net indirect taxes less subsidies received by government) fell from over 60% in the 1970s to 53% in 2017 and similar trends can be seen in other advanced nations: Jim Stanford, ‘The Declining Labour Share in Australia: Definition, Measurement, and International Comparisons’ (2018) 81 Journal of Australian Political Economy 11, 18–27.


121. The 1998 study used Australian Household Expenditure Survey data to generate demand elasticities for 14 commodity groups to obtain estimates of the relative welfare loss for households with different income levels. They found that the welfare loss associated with monopoly power is largest for poor households, which depend on government pensions and benefits for their principal source of income: John Creedy and Robert Dixon, ‘The Relative Burden of Monopoly on Households with Different Incomes’ (1998) 65(258) Economica 285, 285. The 1999 study extended this analysis with more detailed measures of welfare (through equivalent variations) and inequality (using a larger number of households in the Household Expenditure Survey) and confirmed their findings that reduced competition can have substantial effects on the distribution of welfare: John Creedy and Robert Dixon, ‘The Distributional Effects of Monopoly’ (1999) 38(3) Australian Economic Papers 223, 223.


