

Submission to the House of Representatives Standing Committee on Economics inquiry into promoting economic dynamism, competition and business formation

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March 2023

The opinions expressed in this submission are those of the authors. They do not purport to reflect the opinions or views of the University of Queensland.

1. Introduction

We are pleased to have the opportunity to contribute to this inquiry and share our insights on newly identified potential negative economic effects of market power. Our aim is to offer practical guidance on how competition law and procedures can effectively address these issues.

Some of the themes discussed below have been previously considered by the Harper Review and dismissed. However, we believe that there are now compelling reasons to revisit them. For instance, the Harper Review did not recommend the introduction of mandatory pre-merger notification and instead suggested maintaining the current dual pathway for the assessment of mergers under s.50 of the Competition and Consumer Act (CCA). Nevertheless, we will be presenting new arguments that support the need for reconsidering this recommendation.

2. Background

There is a substantial body of evidence that points to a global increase in market concentration. There is also evidence that Australia's economy has become more concentrated. This evidenced was aired in a recent inquiry of the House of Representatives Standing Committee on Economics¹ and, therefore, it will not be reproduced here.

More concentrated markets are not necessarily harmful for society. To use Thomas Phillipon's terminology², there is good and bad concentration. The former arises when concentration is driven by innovative firms gaining market share. The latter may be driven by mergers or acquisitions that aim to reduce competition or by entry of new firms becoming more difficult because of regulation. In his book, Phillipon presents considerable evidence that the rise of concentration in the US economy has been mostly of the bad type. There is also a growing body of evidence, including for Australia, linking more concentrated markets to rising income inequality, lower labour shares, low productivity growth, and high prices and markups, as reviewed by the recent inquiry.

For Australia, Treasury research³ has empirically linked a decrease in the competitiveness of the Australian economy to the slowdown of productivity. The link between competition, innovation and productivity has been recently explored for the German economy. The research⁴ shows that an increase in markups by one percent decreases innovation

¹ Parliament of the Commonwealth of Australia, Report on the implications of common ownership and capital concentration in Australia, 2022. Available at https://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Inquiry_into_the_implications_of_common_ownership_and_capital_concentration_in_Australia/Report.

² T. Phillipon, The Great reversal: How American gave up on free markets, Harvard University Press, 2019.

³ D. Andrews, J. Hambur, D. Hansell and A. Wheeler, Reaching for the stars: Australian firms and the global productivity frontier, Treasury Working Paper 2022-01, 2022.

⁴ B. Ganglmair, N. Hahn, M. Hellwig, A. Kann, B. Peters and I. Tsanko, Price markups, innovation, and productivity: Evidence from Germany, 2020. Available at https://www.bertelsmann-stiftung.de/fileadmin/files/BSt/Publikationen/GrauePublikationen/NW_Price_Markups_ENGL.pdf.

expenditure by 1.7 percent economy wide. For the manufacturing sector, this reduction reaches 3.7 percent. The same study estimates that a decrease in innovation expenditures by 1.7 percent decreases total factor productivity by 1.02 percent. These estimates are similar to other studies for Germany and for other countries.

While the effects of market power discussed above have been well studied, we consider below newly identified mechanisms through which market power can have economy-wide adverse effects.

3. Wage price spiral

During the inflationary era of the 1970s, cost-push theorists developed the idea of a wage-price spiral. The central idea was that unions held market power in labour markets, while large firms had market power in product markets. Hence, unions could demand and get higher wages. Such demands met little resistance because employers could pass cost increases on to consumers.

Concerns about a wage price spiral have been expressed in the current inflationary period, notably by RBA governor Lowe.⁵

However, wages have failed to keep pace with inflation, and this situation shows no sign of changing significantly. As a result, more recent statements from the RBA have played down the risk of a wage-price spiral. However, they have failed to recognise the asymmetry between wages and prices.

Discussing this point in the RBA Bulletin, Suthaharan and Bleakley⁶ state

“There are a number of factors that work against a wage-price spiral emerging, however, implying that the overall risk in most advanced economies is probably quite low, and certainly lower than in the 1970s. One group of these factors relates to the pricing power of workers and firms, which has fallen over the past decades as a result of institutional change and increased globalisation raising competition”.

Suthaharan and Bleakley are correct as regards workers. The ‘countervailing power’ of strong unions has been destroyed by declining union membership and industrial relations legislation prohibiting strikes (except in the limited circumstances of ‘protected industrial action’) and many bargaining practices.

⁵Statement by Philip Lowe, Governor: Monetary Policy Decision, 6 December 2022. Available at <https://www.rba.gov.au/media-releases/2022/mr-22-41.html>.

⁶ Suthaharan, N. and Bleakley, J. (2022), Wage-price Dynamics in a High-inflation Environment: The International Evidence , RBA Bulletin. Available at <https://www.rba.gov.au/publications/bulletin/2022/sep/wage-price-dynamics-in-a-high-inflation-environment-the-international-evidence.html>.

In contrast, globalisation has had little effect on the pricing power of firms in Australia. The trade share of GDP rose significantly between 1970 and 2000. However, this growth largely reflected the disappearance of import-competing manufacturing. This process was largely complete by 2000 and the trade share of GDP has remained stable since then.

Where overseas firms have entered the market, often this is done by taking over Australian firms, rather than through 'greenfield' investment. The consolidation of the dairy processing industry under international firms Fonterra (NZ), Lactalis (Europe) and Saputo (Canada) provides an example. One notable counterexample is Aldi's entry to the Australian supermarket sector.

Dominant firms in most parts of the services sector, such as banking, have not been significantly affected by import competition.

4. Market power and Inflation

Our research on imperfectly competitive markets⁷ provides insights that clarify the relationship between market power and inflation. We have identified a theoretical channel that shows how market power amplifies inflationary shocks, but it does not trigger them. The channel hinges on the concept of a 'strategic industry supply curve.' Under perfect competition, industries supply goods and services as expected. However, when one or more firms have significant market power, prices are higher for any given quantity sold and increase further as demand for the product increases. As a result, firms with market power amplify inflationary shocks that follow a boost in demand, such as the one observed following the COVID stimulus and the end of lockdowns.

The analysis further reveals that firms with market power weigh the benefits of higher prices against the potential loss of sales due to reduced demand and competition. When demand increases, the losses from markups are lower. Although our analysis does not support the simplistic view that market power drives inflation, it illuminates how they interact.

Importantly, our research has a direct implication for the competition test used by the ACCC to assess whether a restricted conduct or a merger is likely to lead to a substantial lessening of competition. The test involves comparing the future state of competition in the relevant market with (the factual) and without (the counterfactual) the conduct or merger. The ACCC analysis assumes (implicitly) an economy in equilibrium. For instance, if it concludes that there's no substantial lessening of competition, then the logical implication is that price-cost margins are similar across both factual and counterfactual scenarios. However, our analysis shows that in the presence of demand shocks, we expect price-cost margins to be amplified when there is market power. This implies changes in both the factual and the counterfactual. As a result, a finding that a conduct or transaction is likely to lessen competition, but not substantially, in the absence of a demand shock could be incorrect. If

⁷ Menezes, F. and J. Quiggin, Market power amplifies the price effects of demand shocks, *Economics Letters*, Volume 221, 2022, 110908.

there were demand shocks, price-cost margins would increase more in the counterfactual than in the factual, which could lead to a finding of a substantial lessening of competition.

5. Market power and wages

In the early days of the US anti-trust movement, it was common to draw a link between monopoly power in product markets and monopsony power in labour markets. Sen. John Sherman argued that a trust not only has the power to raise prices; it also “commands the price of labor....for in its field it allows no competitors”.⁸

As with other aspects of US anti-trust policy, this view fell into disfavour in the late 20th century. The problem of monopsony in labour markets was largely disregarded. It was widely assumed that concentration in product markets would not, in general, contribute to market power in labour markets. Indeed, the wage-price spiral models discussed above implied the opposite: that firms with product market power would not resist union wage demands.

However, as Leigh (2023) notes, these views have now been revised.⁹ Evidence from the US, UK and Europe has demonstrated that increases in labour market concentration are associated with lower wages.¹⁰

The link between product market concentration and labour market monopsony is drawn more explicitly by the US Council of Economic Advisors¹¹, who note that “*Where labor markets align with product markets, firms can have both monopoly and monopsony power*”.

6. Market power and managerial compensation

In general, as observed in the previous section, market power has tended to depress wages and salaries. By contrast, recent research¹² has documented that the rise in market power that has occurred over the last few decades is remarkably like the rise in CEO Pay. This naturally leads to the question of whether managers are paid for market power, which is answered by this research.

⁸ Congressional Record 2457, 1890, quoted in US Council Of Economic Advisers Issue Brief October 2016 , Labor Market Monopsony:Trends, Consequences, And Policy Responses. Available at https://obamawhitehouse.archives.gov/sites/default/files/page/files/20161025_monopsony_labor_mrkt_cea.pdf.

⁹ Leigh, A. (2023), How Uncompetitive Markets Hurt Workers - Speech, Melbourne. Available at https://www.andrewleigh.com/how_uncompetitive_markets_hurt_workers_speech_melbourne#:~:text=With%20market%20power,%20economic%20theory,than%20they%20are%20being%20paid.

¹⁰ Abel, W., S. Tenreyro and G. Thwaites (2018), ‘Monopsony in the UK’, Centre for Economic Policy Research Discussion Paper DP13265; Azar, J., I. Marinescu and M. Steinbaum (2022), ‘Labour Market Concentration’, *The Journal of Human Resources*, 57(S), pp S167-S199.; Bergman, N. K., and H. Kim (2022), ‘Strong Employers and Weak Employees: How Does Employer Concentration Affect Wages?’, *The Journal of Human Resources*, 57(S), pp S200–S250.

¹¹ Issue Brief October 2016, Labor Market Monopsony:Trends, Consequences, And Policy Responses.

¹² Bao, R., J. De Loecker, and J. Eeckhout, ‘Are Managers Paid for Market Power?’, NBER Working Paper No. 29918, April 2022.

Answering this question requires a separation between market power and firm size; market power and firm size are positively correlated, and CEO pay likely increases with firm size. This new research approaches this question by considering that firms take advantage of their market power in the goods market and managers, who are hired in a competitive labour market, contribute to their firm's productivity.

Using data on executive compensation from Compustat between 1994 and 2019, this research assigns on average 45.8% of CEO Pay to market power. Over time, it estimates that 57.8% of the growth in CEO pay is attributed to market power. The main conclusion is that there is a strong link between market power and CEO pay, with firms with market power hiring top CEOs and rewarding them with higher pay. This creates an incentive for managers to seek out firms with market power, leading to a concentration of talent in these firms and exacerbating the productivity gap in the economy. These findings have macroeconomic implications, as the gains in productivity by firms with market power may not be passed on to consumers, resulting in lower social welfare. These potential economy-wide public detriments associated with reduced competition are unlikely to be captured by analysis of the effects of a specific transaction or restricted conduct.

7. Market power and the environment

New research¹³ has uncovered yet another negative impact of market power: limiting the potential for win-win environmental policy outcomes, also known as the Porter Hypothesis. This hypothesis suggests that a well-designed environmental policy can increase social welfare and be profitable for firms. However, the research shows that when competition is intense, the pass-through of a welfare-enhancing emissions tax to consumers may outweigh the costs of emissions abatement for firms. In contrast, firms with market power are more likely to face reduced profits from a welfare-enhancing emissions tax, creating a perverse political economy that could result in lobbying to prevent the introduction of such policies.

This link between competition intensity and win-win environmental policy outcomes highlights a potential public detriment resulting from a conduct or transaction that may substantially lessen competition in a market. The Australian Competition and Consumer Commission (ACCC) can authorise a merger or a restricted conduct (anti-competitive agreements, misuse of market power, and exclusive dealing – the so-called non-per se conducts) if either the proposed conduct or transaction is not likely to substantially lessen competition, or the likely public benefit resulting from the proposed acquisition outweighs the likely resulting public detriment. The ACCC can authorise a per se conduct (cartel conduct, secondary boycotts and resale price maintenance) if the likely net public benefits are positive regardless of the adverse impact on competition, which in these instances will be substantial.

¹³ Flavio M. Menezes & Jorge Pereira, "Imperfect competition, emissions tax and the Porter hypothesis," Australian Institute for Business and Economics DP022023, School of Economics, University of Queensland, 2023. Available at <https://ideas.repec.org/p/qld/uqai/be/2.html>.

However, the ACCC's authorisation process does not capture potential economy-wide detriments, such as reduced innovation, nor does it consider the detriments associated with the existence of market power, such as reduced likelihood of win-win environmental policies. Although this is not a criticism of the ACCC, it highlights the risk that the authorisation process may not always result in socially desirable outcomes.

8. Recommendations

As indicated above, there is a substantial body of evidence that has emerged since the Harper Review suggesting that the Australian economy has become less competitive. There is also a large, and growing, literature that identifies economy-wide negative effects of reduced competition. These include less innovation, lower productivity and labour share of the national income, more inequality, higher prices and markups.

This submission highlighted yet more negative effects of reduced competition. It explained how market power amplifies the inflationary effects of demand shocks, and how it reduces the likelihood of win-win environmental policy outcomes. It also described empirical evidence that links CEO pay to markups, which leads to a growing productivity gap between firms, and lower welfare as productivity gains are not fully passed on to consumers.

Our analysis has two implications which underpin the recommendations below. First, the current substantial lessening of competition test does not contemplate that in an inflationary environment, where inflation is driven by demand shocks, price-cost margins may increase more under the counterfactual than under the factual. While estimating price increases by individual firms, facing a demand shock and distinct market structures, is a difficult exercise, it suggests that mergers that have the potential to substantially lessen competition deserve a degree of scrutiny that is not afforded by the informal notification pathway. There are other reasons too for eliminating the dual path and requiring mandatory pre-merger notification for mergers above a threshold. These reasons have been articulated by the ACCC and include the challenges that arise in global mergers where in many instances there is no notification, or the notification happens too late.

Our first recommendation is, therefore, for the introduction of a single pathway to merger notification with the introduction of mandatory notification. This will allow for closer scrutiny of mergers that have the potential to substantially lessen competition and to consider factors such as the impact of inflationary demand shocks on price-cost margins in the factual and counterfactual.

The second implication of our analysis is that it is difficult, if not impossible, for the ACCC to consider economy-wide detriments associated with a particular transaction or conduct. Indeed, it may be the case that the economy-wide impacts are only measurable when considering the cumulative impact of various transactions or conducts. Taking the existing body of evidence as a whole, and considering that the economy-wide impacts of reduced competition are significant, it is questionable whether a conduct or transaction that substantially reduces competition should be authorised based on estimated net public benefits.

Our second recommendation is for consideration to be given for the net public benefit test in the authorisation process to become a substantial net public benefit test.

The apparent decline of competition in Australia suggests that the current reactive approach of assessing mergers when they are proposed is inadequate. It would be desirable for policymakers to have a clearer picture of the state of competition, and, in particular, an understanding of markets where competition is already inadequate.

Our third recommendation is to consider changes to the CCA to empower the ACCC to conduct market studies and market investigations. This would complement the existing framework where government's approval or direction is required for the ACCC to conduct price inquiries under subsection 95H of the CCA. The Competition commission in the UK has this power and would provide a model.

In markets where competition is already inadequate, the criterion of 'a substantial lessening of competition' is problematic. Any merger involving a dominant firm is likely to exacerbate the problem of inadequate competition. On the other hand, a merger involving only smaller firms might be beneficial.

Our fourth recommendation is that consideration should be given to the adoption of a per se rule, prohibiting acquisitions by dominant firms in markets where competition is already inadequate. Authorisation, under a substantial net public benefits test, would still be available.

9. Conclusion

In summary, the submission highlights additional negative effects of reduced competition on the Australian economy and recommends changes to the current merger notification and authorisation processes. The proposed changes could be explored through a focused Part IV review with consideration given to consequential changes in Part VIIA to empower the ACCC to conduct their own market studies and market investigations.