



**Submission to the
Senate inquiry into
Trade Practices Amendment
(Guaranteed Lowest Prices -
Blacktown Amendment) Bill 2009**

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Executive Summary

This paper argues that the proposed amendment to the Trade Practices Act not be adopted. There are a number of problems associated with legislating against geographic price discrimination. In this paper I concentrate on two problems. The first is the practical problem of cost differentials across geographic space. Successful implementation of this legislation would require the ACCC undertake extensive cost analysis in order to determine whether or not a violation of the Act has occurred. The second problem is philosophical – prices are not just determined by costs, but rather by market conditions. Consumers do not benefit from low costs per se, but rather from profitable businesses. This legislation would effectively constitute a form of price control that would not ultimately benefit the Australian community.

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Introduction

The bill is designed to end the anti-competitive practice of geographic price discrimination, which can potentially drive independent retailers out of the market or deter them from cutting prices. The bill will require large retailers such as major supermarket chains and the oil companies to charge the same price at any location that is within 35 kilometres of another of their sites.

Geographic price discrimination is not an economic problem, even though it generates substantial press and is widely viewed as being somewhat immoral. The case against geographic price discrimination seems somewhat intuitive; the view being that corporations discriminate against the disadvantaged or employ some form of market or monopoly power. This type of argument, however, ignores the economic reality of competition in the market place and enshrines a theoretical construct of competition into law. This type of policy making is likely to lead to inefficiencies and higher prices for consumers. Despite being dressed up as competition policy, this is essentially a subsidy to small business. The consumer ultimately suffers through less choice and higher prices.

Policy concerns about geographic price discrimination are not new. Indeed, for many years this type of discrimination was explicitly illegal in the United States. The regulation economics literature deals with issues relating to geographic price discrimination and it is this literature that I wish to highlight in this submission.

Price Discrimination

F. M. Scherer defines price discrimination as ‘the sale (or purchase) of different units of a good or service at price differentials not directly corresponding to differences in supply cost’.¹ Scherer describes three forms of price discrimination:

- Personal discrimination – discrimination based on the personal characteristics of the customer.
- Group discrimination – discrimination based on the group or market segment characteristics of the customer.

¹ F. M. Scherer, 1970, *Industrial Market Structure and Economic Performance*, Rand McNally College Publishing Company, pg. 253.

- Product discrimination – discrimination based on the characteristics of the product.

Modern economic theory, however, uses somewhat different definitions of price discrimination:

- First degree discrimination – discrimination based on the customers' willingness to pay and broadly conforms to Scherer's personal discrimination definition.
- Second degree discrimination – discrimination based on bulk discounting and does not comfortably sit within any of Scherer's definitions.
- Third degree discrimination – discrimination based on market segments and is consistent with Scherer's group discrimination definition (and possibly his personal discrimination definition).

Geographic price discrimination is a form of third degree price discrimination. Corporations regularly segment their markets by geographic location. Accordingly, business costs are likely to vary by location and price differentials simply reflect that variation. In order to successfully introduce legislation that requires price conformity over a large geographic area, the parliament will need to recognise that price differentials can likely be explained by cost differences. In the USA, the Congress did recognise this point and introduced the 'cost-justification defence'. This becomes a practical concern – costs are likely to vary over geographic space and this can contribute to price differentials.

As Robert Bork has written:²

Persistent price differences in markets with rivals, therefore, are not price discriminations. They necessarily reflect differences in the cost of doing business with different customers. Such differences arise from a variety of factors, including the amounts customers purchase, selling costs, service costs, the performance of distributive functions by the customer, and so on. This fact means that the law should never attack price differentials of this sort. Not only is enormous pressure put on the cost justification defense – which, if it worked perfectly, would succeed in all such cases – but the mere threat of litigation and the expense of establishing the defense, which can be considerable, will inhibit sellers from giving full recognition to cost differences. This handicaps more efficient modes of doing business and reduces or removes incentives for creating them.

² Robert Bork, 1978, *The Antitrust Paradox: A Policy at War with Itself*, The Free Press, pg. 388 – 389.

There is an additional philosophical problem. The notion that price discrimination is harmful is based on the economic fallacy that prices are only determined by costs. To be sure, cost recovery is an important component of any pricing exercise. Prices, however, are determined by supply and demand in a competitive process. A particular problem is that economic costs, particularly opportunity costs, cannot be observed easily, if at all. Post accounting costs can be observed, yet we know that accounting costs are easily restated and manipulated through accounting conventions and assumptions. Any congruence between accounting reality and economic reality is at best after the fact and probably unlikely. Entrepreneurial decision making is forward looking while accounting is backward looking. This is not to denigrate the role of accountants and accounting, but rather to point out that the accounting function is very specific. We now know that accounting is not well suited for regulatory compliance purposes. Cost recovery may well be an appropriate objective for bureaucratic organisations (such as government), but it is not at all clear that this is an appropriate objective for profit-maximising organisations.

What about the Consumer?

The biggest problem with this type of legislation is that it is anti-consumer whilst being pro-small business. There is nothing wrong with promoting small business if the government wishes to do so. The current regulatory burden on small business is a distraction and probably adds no value to their business operations or society at large. Government could usefully reduce that burden. It is not appropriate, however, to promote small business by requiring large organisations to potentially charge higher prices. In no way does this enhance consumer welfare.

In effect, this policy is a form of price control. The great Austrian economist Ludwig von Mises warned against this type of intervention (emphasis added).³

A government that sets out to abolish market prices is inevitably driven towards the abolition of private property; it has to recognize that there is no middle way between the system of private property in the means of production combined with free contract, and the system of common ownership of the means of production, or Socialism. *It is gradually forced*

³ Ludwig von Mises, 1980, *The Theory of Money and Credit*, Liberty Fund, pg. 281.

towards compulsory production, universal obligation to labour, rationing of consumption, and, finally, official regulation of the whole of production and consumption.

Any prohibition of geographic price discrimination must either be so blunt an instrument that it causes great injustice, or it must be so extensively crafted that the regulatory requirements and the subsequent burden be so great so as to massively expand the role of government in setting prices at the suburban level.

Government simply does not have the ability to implement a policy such as this without generating enormous unintended consequences. We have already observed the failure of government to inform consumers about something as simple as daily petrol prices. This policy requires government to not only know prices on a day to day basis, but also to determine whether those prices constitute price discrimination and then to act on that discrimination in a manner that will benefit consumers. In his analysis of the US experience, Dominick Armentano has described the Robinson-Patman Act as ‘an economic and civil liberties nightmare’.⁴ Armentano also describes in detail some of the US court cases that have considered this type of discrimination. He sums up the experience with the terms ‘economic nonsense’ and ‘economic nightmare’.⁵

Consumers do not necessarily benefit from low prices. Consumers do benefit from profitable business though. Profitable corporations are able to lower prices while maintaining quality or increase quality while maintaining price. This is in the long-term interests of consumers. Competition policy needs to operate to ensure that this process occurs. Again it worth looking to Ludwig von Mises:⁶

Profits are the driving force of the market economy. The greater the profits, the better the needs of the consumers are supplied. For profits can only be reaped by removing discrepancies between the demands of the consumers and the previous state of productions activities. He who serves the public best, makes the highest profits.

⁴ Dominick Armentano, 1990, *Antitrust and Monopoly: Anatomy of a Policy Failure*, second edition, The Independent Institute, pg. 171.

⁵ Armentano, as above, pg. 192 – 193.

⁶ Ludwig von Mises, 1949, *Human Action: A Treatise on Economics*, fourth revised edition, Fox & Wilkes, pg. 809.

Conclusion

This legislation will not enhance consumer welfare in Australia will act as a very blunt instrument to assist small business. If the government does wish to assist small business there are far more appropriate actions it could undertake. This legislation will impose huge costs on the Australian community with little or no benefit.