

## **SUMMARY AND WORKING DRAFT**

for discussion purposes only at the Fourth Annual Competition Commission, Competition Tribunal and Mandela Institute Conference on Competition Law, Economics and Policy in South Africa

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### **A More Effective Efficiency:**

#### ***The normative potential of constitutional economics to achieve the stated objectives of the Competition Act***

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## **INTRODUCTION AND SUMMARY**

This paper is concerned with the possibilities of a new conceptual and normative approach to efficiency in competition law which may further all of the stated objectives of the Competition Act 89 of 1998 (“the Act”). It proceeds from the assumption that a new normative framework is needed to understand the goals and policy of competition regulation as expressly set out in the preamble and section 2 of the Act.

Much of the economic theory regarding efficiency that has dominated comparative competition policy over the past two decades was limited to the maximisation of dynamic, allocative and productive efficiency, often measured by the consumer welfare or total welfare standards. This narrow, almost exclusive, focus on aggregate efficiency understood in this way is problematic for a developing country; in addition, it ignores the additional, explicit objectives of South African competition policy.

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<sup>1</sup> Member, Johannesburg and New York Bar. This is a summary and working draft of a longer paper that is currently a work-in-progress. I seek to summarise that paper so as to facilitate discussion and invite criticism of the approach described, particularly as to the limits of the reconceived content of the notion of efficiency. I do hope that this summary has not sacrificed clarity. Finally, I invite suggestions and recommendations on further literature with which to engage in developing these ideas.

The question arises whether efficiency, so defined and applied, constitutes an obstacle to achieving the other stated and equally important objectives of the Competition Act.

The argument in favour of a broader interpretive approach to efficiency proceeds along the following lines: competition law/antitrust, when traced back to its US roots in the Sherman Act sought to produce and preserve an economic environment in which the competitive process, and antitrust law, would create and promote market conditions in which firms would behave as rivals and in which new firms would be able to enter the competitive race and challenge these existing firms. This original focus on pure market dynamics invariably called for a more nuanced analysis of markets. Efficiency in this era was the measure of the market's delivery of these market conditions. Early US and European competition law, particularly in Germany, emphasized the importance of market power invariably subverting the competitive process.<sup>2</sup>

With the advent of Chicago School economics, the focus shifted to a narrower outcome-based approach to efficiency, concerned primarily with a determination of the possibility of output reduction and/or price increases for identifiable firms. While this approach had the advantage of introducing a greater measure of precision into the adjudication of competition disputes, it excluded broader contextual factors that could be relevant and limited the understanding of the objectives and goal of competition policy.

The historical proposition is that antitrust had a radical goal which has been tamed, reduced, tempered, if not eliminated, by a narrow focus on efficiency conceived in this way. Competition law, or antitrust, was a deliberate economic policy choice,

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<sup>2</sup> See Fox, Sullivan and Peritz *US Antitrust in a global context* (2004) and Gerber *Competition law in 20<sup>th</sup> century Europe* (2001)

informed by a desire for a certain type of market and seeking certain market conduct from its players. At root, it was concerned with the power of market actors and to ensure that that power was distributed and used in a fair manner to ensure competition between enterprises and, ultimately, for the benefit of consumers. This radical vision faded with the rise of the narrower preoccupations of the Chicago school.

In the South African Act, these type of radical interventionist distributive and broader development goals are explicitly claimed. The Act is neither coy nor agnostic about its agenda to address the historical economic inequalities and poor distribution of opportunities to participate in the market that characterise our past. The Act replaced earlier economic policies favoured for the post-transition market (nationalization of key industry as a means to restructure the imbalances and concentrations of the apartheid market most particularly).

These concerns, in turn, engage with broader discussions and concerns of development economists and other market theorists, about the role of competition law in developing countries, as well as parallel poverty alleviation/development campaigns and even the regulatory response to the global financial crisis. Underpinning this all is a paradoxical belief that the market is both an available and uniquely effective instrument for development and wealth creation, while recognizing the inequalities and disastrous effects of unconstrained market conduct.

Given that the narrow concept of efficiency is a normative, even ideological, choice, this paper argues for a new broader concept of competition achieved through efficiency, better aligned to the objectives of the Act. I turn to consider the theoretical context of this proposition.

As Professor Eleanor Fox has stated, freedom and efficiency were equated in the

Chicago worldview<sup>3</sup>. For example, the IMF and World Bank's conditionality of loans to developing countries on the implementation of market liberalization measures followed what Fox terms an economic prescription of liberalisation and privatisation. The economic law of antitrust regulation shrunk and regulation was dismantled. In this era, "minimal law and maximum markets" was the anthem. But we now know that this lack of oversight and clear policy goals had catastrophic effects on development.<sup>4</sup>

The greatest challenge therefore facing developing countries, and South Africa more specifically, is that of inequality – identified as a root cause of crime and broader socio-political disaffection manifest through events such as so-called service delivery protests. This inequality gap also manifests in its human and tragic impact on literacy, life expectancy, education and employment potential – all critical development drivers that reverse the creation of new consumers.

Fox argues that the ideology that drove us into the global financial crisis causes us to misdiagnose or disregard the competition or market effects of the problems of poverty and powerlessness, or inequality. Our commitment to free markets has obscured the poverty problem that their effective (as opposed to efficient) operation may address. However, markets also contain the potential to help people help themselves, or create and distribute wealth so as to alleviate poverty and inequality. In other words, while the markets created and perpetuated the problem, we remain committed to a market mechanism to address it. As Fox puts it, in this paradox the Washington Consensus and the UN Millennium Development Goals meet.

It is arguably now common wisdom that inclusive, or integrated, growth is what

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<sup>3</sup> *Efficiency, Poverty and Markets* Fox: presentation at University Paris Dauphine, 11 March 2009 (author's copy)

<sup>4</sup> see e.g. *Globalization and its Discontents* J Stiglitz (2003); *The Bottom Billion* P Collier (2008)

developing countries need. While regulation and external investment institutional pressure focuses on reducing the governmental and regulatory barriers to development, there is an argument made by Fox that antitrust law also can tear down the “private power roadblocks” on this journey to greater economic equality and development.

As Fox summarises:

“the powerful and mobile profit not only from markets but from protection, while the powerless suffer what they must from market blockage. [And] all in the name of a notion of efficiency, of aggregate wealth as the [holy grail]. ‘Efficiency’ [is] defined and applied in a way that discounts distributional concerns as ‘messaging-up’ efficiency [and] forgives the political lapses creating inefficiencies that hurt the poor.”

In this analytical frame, efficiency is often set up in opposition to development, as if the latter inevitably requires the sacrifice of the former; rather, development- or other equality-enhancing outcomes could be understood as efficient in themselves and this is an important part of the reconceptualisation of efficiency suggested here. In addition, dynamic efficiency is often lost in the static model of efficiency as are the technological advances, in particular, that are critical to development and the developing countries’ context.

I turn now to consider these issues in the context of the South African Act.

Sutherland describes what I take to be the general and majority view of the goals of the Act and its notion of efficiency, as well as the assumption that efficiency is not always the price paid for implementing the broader objectives of the Act:

Sutherland notes that:

*“the preamble recognises that South Africa’s discriminatory past resulted in a skewed distribution of ownership and control, inadequate restraint on anti-competitive trade practices and unjust restrictions on full and free participation in the economy by all South Africans. It acknowledges that the economy should be open to greater ownership by a greater number of South Africans and that a credible competition*

*law and effective structures to administer that law are necessary for an efficient functioning economy. It stresses that 'an efficient, competitive economic environment, balancing the interests of workers, owners and consumers and focused on development' will benefit all South Africans."*<sup>5</sup>

*"it will satisfy even the hardened Chicago scholar that efficiency is mentioned as a goal in the preamble and as the first two objectives in section 2. However, proponents of the notion that efficiency should be the only goal of competition law will regard the other objectives mentioned in the Act as inappropriate for a competition law regime. It is difficult to see how effect can be given to all of them. They often will conflict. A particular problem exists with what Eleanor Fox calls the 'equitable goals' of South African competition law: the Act clearly is also aimed at promoting social justice in general and equal opportunities to participate in the economy in particular. Many competition lawyers (mostly under influence of Chicago scholars) have been critical of the notion that competition law should protect small undertakings and promote the spread of ownership, as this may undermine efficiency. For these commentators, increases or decreases in competition depend on the efficiency of the firms in the market and not on the size or large number of them. The notion that competition law should assist in redressing the injustices of South Africa's past racial policies is unique to South Africa, yet it equally may be difficult to achieve this without any cost to efficiency, especially in the short term. South African competition law may be more complex and less systematic than a system that is purely aimed at promoting efficiency. Nevertheless, the Act does not give South African competition lawyers a choice but to grapple with a multitude of goals. The Act with its range of goals was born out of dramatic political events from which it cannot be isolated.*

*So the question then remains: Exactly how should the preamble and section 2 impact on the practical resolution of competition law disputes? At least the Act makes it clear that the equitable objectives are not to be promoted without more. . . . As Eleanor Fox concludes: 'If expectations are high that the new competition law will visibly change the terms of economic participation in favor of the historically repressed black majority in South Africa, they are likely to be unfulfilled; the stated purpose of the competition could give false hope. In view of the clarity and limits of the law, however, it is doubtful that expectations will be high for benefits other than the right to compete on the merits, which itself is empowering.*

*But it remains difficult to balance these goals in promoting competition. Fox points out that, '[i]n spite of these multiple, and sometimes incompatible, aspirations, ninety-five percent or so of the body of the statute reflects relatively well-tested principles of competition law.'* She

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<sup>5</sup> Competition Law of South Africa Sutherland p4-3

*mentions only two exceptions, section 10(3), which allows the Commission to exempt agreements or restrictive practices if they promote the ability of small businesses or firms controlled by historically disadvantaged persons to compete, and section 12A(3), which obliges competition authorities when adjudging mergers to consider the ability of small businesses and historically disadvantaged persons to become competitive. . . .*  
*The preamble and the list of objectives of South African competition law will exert influence beyond these two provisions. . . . Hence, the statutory endorsement of both efficiency and equitable goals here means that South African lawyers must be cautious of foreign, and especially American, authorities that regard efficiency as the only goal of competition law”<sup>6</sup>*

In summary, this view acknowledges the socio-economic and -political context and structure of the South African economy, sees the ‘equitable goals’ of the Act, but then sets them up in opposition to each other, rather than redefining efficiency to include and constitute these selfsame equitable goals.

It is against this broader and historical context, and in rejection of the assumed trade-off between these goals and efficiency (as currently and narrowly defined) that this paper posits that a reframing of efficiency analysis to more actively engage with the development and distribution goals of the Act is needed. This shift sacrifices narrow firm-focused analysis that ignores the progressive goals of the Act in favour of a new efficiency analysis paradigm, better suited to developing country circumstances.

The Act explicitly links competition law and policy to development and inequality-lessening moves:

The first two sentences of the preamble to the Act state that it is enacted in order to

*“provide all South Africans equal opportunity to participate fairly in the national economy  
achieve a more effective and efficient economy in South Africa . . .”*

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<sup>6</sup> Sutherland p 4-4 – 4-5

Section 2 states that

*“the purpose of this Act is to promote and maintain competition in the Republic in order –*

- (a) to promote the efficiency, adaptability and development of the economy;*
- (b) to provide consumers with competitive prices and product choices;*
- (c) to promote employment and advance the social and economic welfare of South Africans;*
- (d) to expand opportunities for South African participation in world markets and recognise the role of foreign competition in the Republic;*
- (e) to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the economy; and*
- (f) to promote a greater spread of ownership, in particular to increase the ownership stakes of historically disadvantaged persons.”*

Efficiency appears explicitly in sections 4(1)(a)<sup>7</sup>, 5(1)<sup>8</sup>, 8(c) and (d)<sup>9</sup> and 12A(1)<sup>10</sup> of

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<sup>7</sup> Section 4(1)(a):

*“an agreement between, or concerted practice by, firms, or a decision by an association of firms, is prohibited if it is between parties in a horizontal relationship and if it has the effect of substantially preventing, or lessening, competition in a market, unless a party to the agreement, concerted practice, or decision can prove that any technological, efficiency or other pro-competitive gain resulting from it outweighs that effect”*

<sup>8</sup> Section 5(1):

*“an agreement between parties in a vertical relationship is prohibited if it has the effect of substantially preventing, or lessening, competition in a market, unless a party to the agreement can prove that any technological, efficiency or other pro-competitive gain resulting from that agreement outweighs that effect ”*

<sup>9</sup> Sections 8(c) and (d):

*“it is prohibited for a dominant firm to –*

*. . .*

*(c) engage in an exclusionary act, other than an act listed in paragraph (d), if the anti-competitive effect of that act outweighs its technological, efficiency or other pro-competitive gain; or*  
*(d) engage in any of the following exclusionary acts, unless the firm concerned can show technological, efficiency or other pro-competitive gains which outweigh the anti-competitive effect of its act –*

- (i) requiring or inducing a supplier or customer to not deal with a competitor;*
- (ii) refusing to supply scarce goods to a competitor when supplying those goods is economically feasible;*
- (iii) selling goods or services on condition that the buyer purchases separate goods or services unrelated to the object of a contract, or forcing a buyer to accept a condition unrelated to the object of a contract;*
- (iv) selling goods or services below their marginal or average variable cost; or*
- (v) buying-up a scarce supply of intermediate goods or resources required by a competitor.”*

the Act. Significantly, “efficiency” is not defined in the Act and has, traditionally, been defined in the Chicagoan sense of a static model of allocative and distributive efficiency, typically tested against a welfare standard (whether competitor/producer welfare, consumer welfare or total welfare) in a firm- and market-specific context.

But perhaps the Act invites, or, at minimum, permits of, a reading that has wider content, more closely linked to the broader purpose and objectives of the Act and more faithful to the explicit policy objectives underpinning South African competition regulation.

Efficiency as a shorthand for concerns about the bottom-line reduction of costs and the increase of a firm’s output is of course implied, but the greater potential scope of efficiency should be considered. A consideration of the sections and textual context in which efficiency appears in the Act, the sense that efficiency must relate to the purpose and objects of the Act, and therefore has the potential to mean something other than a narrow economic view of firm-specific efficiency, is inescapable.

So how do we get there using a justifiable normative framework? This paper suggests that the work of Wolfgang Kerber<sup>11</sup> building on that of JM Buchanan, described below, is a useful starting point. In summary, Kerber argues for what he calls ‘constitutional economics’. Kerber proposes

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<sup>10</sup> Section 12A(1)

*“whenever required to consider a merger, the Competition Commission or Competition Tribunal must initially determine whether or not the merger is likely to substantially prevent or lessen competition, by assessing the factors set out in subsection (2), and –*

*(a) if it appears that the merger is likely to substantially prevent or lessen competition, then determine -*

*(i) whether or not the merger is likely to result in any technological, efficiency or other pro-competitive gain which will be greater than, and off-set, the effects of any prevention or lessening of competition, that may result or is likely to result from the merger, and would not likely be obtained if the merger is prevented ”*

<sup>11</sup> Chapter 6 (*“should competition law promote efficiency? Some reflections of an economist on the normative foundations of competition law”*) in Drexler, Idot and Moneger (eds) *Economic Theory and Competition Law* (2009)

*“another normative perspective based upon constitutional economics which may lead to a more differentiated normative approach to competition law. Its basic idea is that the preferences of citizens should be the relevant normative criterion for appropriate decisions about the objectives of competition policy. This will lead to a different perspective on the questions of how, to what extent, and what kind of economic efficiency should be considered in the different realms of competition law. It might also allow for more consideration of normative issues currently emphasized primarily by legal scholars, such as protection of rights of market participants or concepts as ‘competition on the merits’.”*

He assumes a Rawlsian original position and poses the question about what sort of policy and outcomes we would want to serve as competition law if we did not know whether we would be the beneficiaries or victims of its outcomes. He suggests that this thought experiment demonstrates how fulfillment of the Kaldor-Hicks criterion for efficiency, or utility, is deficient and unable to engage with these concerns. As he explains:

*“in contrast to traditional welfare economics, Buchanan (as the most important representative of constitutional economics) argued that the decisive normative criterion is voluntary individual consent. By consenting to transactions or to mandatory rules of society, they reveal their preferences and legitimize contracts and mandatory rules. This notion is entirely compatible with notions of private autonomy and democracy, as developed in the Western legal tradition. Consent as normative criterion is very close to the Pareto criterion, because if, as a result of policy, at least one person is better off and no one is worse off, then it can be suggested that all persons can agree on the measure. In contrast, the fulfillment of the Kaldor-Hicks criterion is not sufficient to lead to the consent of all persons involved, because there can be persons who will be worse off.”*

As a result, recognition of a distributional or developmental imperative, rather than merely acceptance of a theoretical potential of compensation for any loss, follows when one considers the likely content of citizens’ preferences.

Kerber then develops the normative framework of constitutional economics as follows:

*“What is the different perspective of this normative approach in comparison to a welfare economics approach? The decisive difference*

*is that the preferences of citizens are viewed as the ultimate normative criterion.<sup>12</sup> They should decide on the question, to what extent allocative efficiency and/or dynamic efficiency should be strived for, to what extent competition law should protect consumers from exploitation or competitors from being hurt through predatory strategies and to what extent society is willing to sacrifice some 'total welfare' in order to prevent redistributions through market power.*

*. . . .  
The constitutional economics approach to the goals of competition law is a purely economic one: it argues that market rules are 'optimal', if they correspond to their preferences (and values).*

*. . . .  
it can be suggested that citizens would appreciate both an efficient allocation of resources and the generation and spread of innovations, because it can be expected that both increase their wealth. This implies that static and dynamic efficiency are important and that any potential trade off between these two goals would be solved by the empirical question about the relative importance of static and dynamic efficiency for increasing the fulfillment of the citizens' preferences. Much more difficult is the question of whether the citizens would agree on an unconditional application of the total welfare standard (Kaldor-Hicks criterion). Restrictive agreements, mergers, and business behaviours of dominant firms would always be allowed if total welfare increases, irrespective of any redistributive effects between the involved firms, the competitors, the firms on up- or downstream markets, and the consumers. Firms and consumers would not be protected against redistributions through market power. Although the total welfare standard would ensure that 'victims' of market power or (total welfare increasing) predatory behaviour could be compensated, they would lose without having a claim for compensation. It is very doubtful, whether a sound argument can be made that, in the long run, all persons would win through the total welfare standard, because they can be both winners and losers in different situations.*

*. . . .  
the citizens of a society are not only consumers but also owners of production factors as, in particular, capital and labour, and are therefore interested in income from interests, wages, and profits. From the perspective of the interests of the citizens it is not obvious why competition policy should only take into account the welfare effects of mergers and business behaviours on the citizens as consumers but not the welfare effects on the same citizens as owners of firms and production factors.*

*. . . .  
Therefore the normative asymmetry which holds that competition law is only about the protection of the consumers' interests and that the interests of all other firms in the upstream markets are irrelevant, is hard to justify from a constitutional economics perspective.*

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<sup>12</sup> Arguably expressed through their representatives in the legislature, and, hence, in the statutory formulation of the Act.

...  
*Part of these preferences might refer to the wide-spread normative notion that the emergence of profits and losses in market competition should be linked somehow to firm performance ('competition on the merits'). In any society citizens have more or less strong convictions about the question of whether the profits of firms or the income of others are justified. This is only partly a question of the 'inequality' of wealth distribution ('distributive justice') but reflects more the dimension of 'commutative justice'. To a large extent the answer depends upon whether firms deserve their profits or losses due to their good or bad performance. If firms have been able to incur large profits because they have carried out successful strategies, lobbied for protective measures or built up market power positions, then most citizens would view these profits as less justified than those which are the result of the innovation of new and better products or cost-decreasing production technologies. A logical consequence is that such considerations might be legitimate arguments in the discussion about the goals of competition policy from a constitutional economics perspective.*

...  
*The problem is that economics has not yet developed normative concepts that integrate the idea of protected rights for individual persons or firms into their normative welfare-theoretic approach. The traditional efficiency approach (static and/or dynamic efficiency, consumer welfare or total welfare concept) is too crude to be capable [of including] this dimension. "*

This constitutional economics normative framework engages with the objectives or goals of the Act set out in its preamble and section 2. Put another way, this demonstrates how the following factors all point to the reframing of efficiency suggested here: the policy concerns of the legislature in enacting the Act, the interest of adjudicators in fidelity to the Act and the external realities of South Africa's economy.

The foreseeable outcomes of this shift may be criticised in a number of foreseeable ways.

First, one could anticipate criticism that this normative framework may create an overbroad role for competition law adjudicators, whether the Commission, Tribunal or Appeal Court. However, such criticism ignores that precisely such a role is cast in the Act itself and has not been fully performed to date, largely due to slavish

repetition of Chicago and other comparative economic and competition policy norms and arguments by these decision-making bodies.

Second, this approach could be cause some discomfort or concern that it is anti-business and imposes obligations on firms that would run counter to their primary goal of profit maximization and the creation of shareholder value. However, this ignores the shift already underway in which the commercial realities faced by companies include precisely these contextual, development-orientated and external factors. The ascendancy of phenomena such as integrated reporting, sustainability, corporate governance concerns, triple-bottom line reporting, corporate social responsibility and other manifestation of so-called value investing strategies confirm that these factors are already the valid concern and focus of business, surprisingly well-aligned with competition policy.

The related concern of the type of evidence that would be required for decision-making in this new efficiency paradigm is also misplaced. Given the fact that firms are already concerned with reporting, capturing, growing and recording the value of their activities in this way, that type of data and information would be the type of evidence that could be used by competition law practitioners in evaluating the efficiency of a given course of conduct by a firm.

Finally, there is the concern that this new efficiency paradigm would have an inevitable and consequential increase in the complexity and poly-centricity of the adjudicative function in the competition arena. In response, the multi- and cross-disciplinary skills and resources that are already available at both the Commission and the Tribunal where competition lawyers and economists work in an integrated and collaborative way are precisely the sorts of skills and resources that are required in this new paradigm. Accordingly, it does not suggest or require anything novel or

additional from decision makers.

## **CONCLUSION**

Finally, even were it possible to reconcile a narrow Chicagoan conception of efficiency with the express language of the Act's preamble and section 2, the efficiency test set out elsewhere in the Act requires more than this mere reconciliation. It requires a new normative conception of efficiency.

This is so because the references in that test to technological and other pro-competitive gains are indicative of the legislature's desire that dynamic efficiency must be considered, at least. There also is clearly a need to develop a framework that does not set these factors up in opposition to each other, nor that treats them as somehow duplicative of each other. Rather, a conceptualization of efficiency that harmonises with these factors, and thereby gives effect to the objectives, goals and policy underpinning the Act is required.