Merger Policy for Small and Micro Jurisdictions

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Introduction: The Importance of the Question

Merger policy is an important tool for limiting privately-erected artificial barriers to competition. Its unique qualities, mainly the fact that it is applied ex ante in order to prevent external changes in market structure which harm social welfare, and the fact that it is the most effective tool in a competition law's toolbox for limiting oligopolistic coordination, serve to explain its spread around the world. Countries of all sizes and economic characteristics have adopted it into their competition laws, from India to Guernsey, from China to Barbados. Indeed, the number of countries with merger regulation has increased from 8 in 1989 to more than 110 in 2009, and the number is still growing.[1]

This wide-spread adoption raises the question of whether there is a one-size-fits-all merger policy, or whether some jurisdictions' economic characteristics affect their ability to effectively apply a merger policy in a way which requires some fine-tuning. This question, which generates interesting scholarly and practical debates,[2] is addressed in this paper, focusing on small and on micro jurisdictions. The latter, in particular, bring some of the tradeoffs involved in the design of merger policy to an extreme and provide an interesting and under-explored case study.

Two forces push and pull merger policy. On the one hand, the "follower push" whereby jurisdictions- mostly small, developing or young- benefit from transplanting and following the laws of large, developed jurisdictions with efficient and effective merger regimes.[3] The follower push is often comprised of both internal and external forces. On the other hand, the "unique characteristics pull" whereby the characteristics of a jurisdiction affect its ability to

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[1] See Simon J. Evenett, *The Cross-Border Mergers and Acquisitions Wave of the Late 1990s*, 9655 NA'L BUREAU OF ECON. RESEARCH WORKING PAPER SERIES (2003); White & Case LLP, *White & Case Survey Reveals 115 Jurisdictions with Merger-Control Laws Worldwide* (Jan. 14, 2009) , http://www.whitecase.com/press_01142009.

[2] For some recent books see, e.g., MARCO BOTTA, MERGER CONTROL REGIMES IN EMERGING ECONOMIES- A CASE STUDY ON BRAZIL AND ARGENTINA (2011); A. E. RODRIGUEZ & ASHOK MENON, THE LIMITS OF COMPETITION POLICY THE SHORTCOMINGS OF ANTITRUST IN DEVELOPING AND REFORMING ECONOMIES (2010). For the effects on limited resources on competition law see, e.g., Michal S. Gal, *When the Going Gets Tight: Institutional Solutions When Antitrust Enforcement Solutions Are Scarce*, 41 LOY. U. CHI. L. J. (2009). Many of the discussions in the OECD, UNCTAD and ICN focus on the effects of different economic characteristics on optimal competition law.

[3] Of course, the merger regimes of large, developed jurisdictions are not always similar. The major follower push is towards US or EU law.

effectively enforce a transplanted law and pull towards adopting a merger policy that best fits its characteristics. Designing a merger law mandates each jurisdiction to find its optimal balance between these two forces and may vary from one jurisdiction to another, depending, inter alia, on the jurisdiction's trade ties and the effectiveness of its enforcement system. Yet these forces do not necessarily lead in different directions; Rather, many parts of a merger regime may fit both the follower and the followed jurisdictions (e.g., adopting a Significant Lessening of Competition test as a benchmark for merger illegality). The challenge is to identify those instances in which the unique characteristics pull leads in a different direction and is stronger than the follower push and to design rules accordingly.

Chapter I briefly explores the two forces noted above. The following chapters focus on the "unique characteristics pull." Chapter II introduces the methodology. Chapter III then explores the effects of the unique characteristics of small size on merger policy. This paper attempts to carry the analysis one step further than that previously performed by the author[4] by proposing a methodological framework to assist in the analysis and by focusing on aspects not previously explored. Chapter IV performs such an analysis for micro economies, a subject which so far has been largely neglected in the literature. Of course, dealing with all aspects of merger policy in such jurisdictions is beyond the scope of a short paper, but some relevant observations and suggestions are offered, based on theoretical observations as well as real-world examples.

Chapter I: The Push and Pull of Optimal Merger Design

The Follower Push[5]

Strong motivations exist to follow the merger policies of other jurisdictions, even if the imported law does not completely match domestic conditions. These motivations are generally stronger the smaller the jurisdiction, the less developed it is, and the greater the perceived success of the merger policy in the followed jurisdiction. Yet the strength of such motivations may differ among jurisdictions. These motivations are sketched briefly below. [6]

Following another's rules may result from external pressures of foreign jurisdictions or international institutions. In some cases such pressure is subtle, and results from a wish to liberalize international trade or to create a common ground for understanding, applying and cooperating on issues of competition laws around the world.[7] In other cases the adoption of certain competition laws serves as a requirement of trade or financial benefits (e.g. loans by the World Bank). Yet it is interesting to note that while the European Union requires in its trade agreements some level of similarity in the application of competition laws,[8] these

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[4] MICHAL S. GAL, COMPETITION POLICY FOR SMALL MARKET ECONOMIES (2003); Michal S. Gal, *Size Does Matter: General Policy Prescriptions for Optimal Competition Rules in Small Economies*, 73 U. OF S. CAL. L. REV. 1438, 1468 (2001); Michal S. Gal, *The Effects of Smallness and Remoteness on Competition Law - The Case of New Zealand*, 14(3) COMPETITION & CONSUMER L. J. 292 (2007).

[5] For elaboration see Michal S. Gal & Jorge Padilla, *The Follower Phenomenon: Implications for the Design of Monopolization Rules in a Global Economy*, 76(3) ANTITRUST L. J. 899 (2010).

[6] For elaboration see Michal S. Gal, *The 'Cut and Paste' of Article 82 of the EU Treaty in Israel: Conditions for a Successful Transplant*, 9(3) EUR. J. OF L. REFORM 467, 471-74 (2007).

[7] *See, e.g.*, the International Competition Network, http://www.internationalcompetition network.org (last visited Oct. 21, 2012).

[8] *See, e.g.*, Euro-Mediterranean Agreement establishing an Association between the European Communities and their Member States, of the one part, and the State of Israel, of the other part, 2000 O.J. (L 147/3), art. 36 ;Agreement on the European Economic Area, O.J. 1994 (L 1), art. 53 to 64.

requirements do not apply to merger law. Indeed, as elaborated elsewhere, copying its merger regime -particularly its mandatory notification procedure- might create a boomerang effect on its firms.[9]

More often following one's law is voluntary, based on internal motivations. Adoption of "ready-made" and pretested rules saves the costs of determining what content ought to be given to the law. Moreover, benefits flow from the transplanted law's application in its home jurisdiction: an established law has a long history of implementation, interpretation, and academic discourse in its saddlebag, and such sources continue to flow with its on-going application, thereby generally increasing legal certainty. The transplant can also help push through new concepts and ease their acceptance.

Additional benefits arise when we add trade to the analysis. One benefit is a reduction in the learning and compliance costs of firms wishing to trade beyond their jurisdiction which, in turn, serves to create a more competitive environment.[10] Legal transplants reduce the costs of domestic exporters of learning which competition law issues they might face in the followed jurisdiction. For the same reason, transplants may increase the incentives of foreign firms to import into the follower's market, all else equal.[11] Finally, transplants might better enable competition authorities to work together towards joint solutions to cross-border mergers. These considerations might explain, at least partially, the fact that Greenland and Faroe Islands, which are Danish political dependencies, have followed the Danish Competition law.

The Pull: The Effect of Unique Characteristics on Optimal Merger Policy

Legal transplants can be unsuccessful and even harmful if they do not deal effectively with the special characteristics of the following jurisdiction. Relevant characteristics include not only socio-economic ones but also enforcement conditions, such as the level of economic analysis that can be performed at all levels of the decision making process, the legal and practical tools at the decision maker's disposal to gather the relevant information, the legal weight given to a decision by an expert decision maker, and political influences on the decision maker. As a result, laws which may promote efficiency under certain conditions might instead generate high error costs under inferior institutional conditions that would, in turn, reduce domestic welfare.[12]

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Accordingly, designing an optimal merger law requires creating a balance between these two competing forces. As argued below, the special characteristics of small and of micro economies leave many of the merger policy prescriptions of large economies intact; yet in some cases the unique characteristics pull mandates legal changes. But before we explore possible deviations, Chapter II focuses on a methodological tool to assist in the analysis.

Chapter II: Decision Theory Methodology

[9] GAL & PADILLA, *supra* note 5. Indeed, in most trade agreements there is no requirement to follow merger policy.
[10] *See, e.g.*, GAL, *supra* note 6.
[11] Of course, the content of the domestic law is also an important parameter. The stricter the law generally the higher the entry barriers it creates.
[12] Mark A. Dutz & Maria Vagliasindi, *Competition Policy Implementation in Transition Economies: An Empirical Assessment*, 44 EUR. ECON. REV. 762, 770 (2000).

The basic challenge for the design of a merger policy is similar everywhere: Creating an efficient and cost-effective regime. Indeed, all jurisdictions seek the optimal balance between a theoretically-optimal merger regime which "gets it right" every time and the practical costs such a review creates, including the length and costs of the proceedings. Yet, as this paper elaborates, the special characteristics of some economies affects the size of the costs involved and thus the optimal set of rules.

To assist us in making this claim, we make use of decision theory. This methodology, first introduced by Ehrlich and Posner[13] and later developed in the competition law realm by Beckner and Salop,[14] Popofsky,[15] Kerber,[16] Evans and Padilla,[17] and others, sets out a process for choosing among potential rules when information is costly and therefore imperfect, in order to design effective and practical legal rules. Accordingly, the rule-maker must balance between process costs and error costs imposed by the chosen rule on decision makers (including the Competition Authority, the merging parties and potential parties to a future merger).

Process costs include information costs (e.g., the costs of gathering factual information such as the market shares of the parties seeking to merge and of their rivals and the height of entry barriers into the market) as well the costs resulting from the decisional process (e.g., the operational costs of the Competition Authority and the courts; the costs of analyzing the relevant information; the loss of revenue by the merging parties resulting from postponing the merger until a decision has been reached). Error costs arise from a decision based on imperfect information and include “false positives” (costs from condemning a merger that does not harm welfare) and “false negatives” (costs from allowing a merger that harms consumers).

The decision maker must determine whether the error costs justify an investment in process costs, and if so- in what type of information and who should provide it. Let me give two intuitive examples. Safe harbours include those cases in which error costs from a presumption that the merger will not significantly harm competition are so low that they do not justify an investment in seeking further information beyond the factual finding of very low market shares or turnover of the merging parties. Likewise, the decision to move to a second stage in-depth analysis of a proposed merger is based on the assumption that the additional process costs are justified by the benefit to society from the reduction of error costs from wrongful merger decisions. Decision theory supports the general conclusion that given high information costs of analyzing the potential effects of a proposed merger, where the costs of false positives are much higher than those of false negatives, merger policy should be more lenient, and vice versa.

[13] Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. OF LEGAL STUD. 257 (1974).
[14] C. Frederick Beckner III & Steven C. Salop, *Decision Theory and Antitrust Rules*, 67 ANTITRUST L.J. 41, 43–5 (1999).
[15] Mark S. Popofsky, *Defining Exclusionary Conduct*, 73 Antitrust L.J. 435 (2006); Mark S. Popofsky, *Section 2, Safe Harbors, and the Rule of Reason*, 15 Geo. Mason L. Rev. 1265 (2008).
[16] Wolfgang Kerber, *Competition Policy with Optimally Differentiated Rules Instead of ‘Per Se Rules Vs Rule Of Reason’*, J. OF COMP. L. ECON. 2(2), 215 (2006).
[17] David S. Evans & A. Jorge Padilla, *Excessive Prices: Using Economics to Define Administrable Legal Rules*, 1 J. OF COMPETITION L. ECON. 97 (2005).

These decision-theoretic considerations apply to all jurisdictions. Yet the special characteristics of some economies may change the optimal rules because they affect the relative size of process and/or error costs . As elaborated throughout this paper, small and micro economies affect both types of costs. For example, given the more limited effect of the market's invisible hand, false negative error costs are often much more significant (in relative terms) than in large economies. Accordingly, decision theory provides us with a methodological tool to recognize the effects of size and to decide which rules are cost-effective and which are not. The rest of the article explores some specific implications. These implications fall into two groups. In the first, the relative size of process and/or error costs might lead to the adoption of a completely different legal rule than large economies. In the second, the size of these costs might strengthen the case for adopting a law which is optimal to both large and small economies, because the relative price to be paid by a small or a micro economy for a sub-optimal law is higher than that paid by a large one.[18]

Chapter III: Small Economies

A. Definition[19]

For the purposes of this paper, a small economy is defined as an independent sovereign economy that can support only a small number of competitors in most of its industries when catering to demand. Market size is influenced by three main factors: population size, population dispersion, and the degree of economic integration with neighboring jurisdictions. Accordingly, if a country with a small population is economically integrated into a large one (e.g., Andorra into Spain), it will not be considered small for competition law purposes. Some examples of small economies include New Zealand, Malta, Singapore, Hong Kong, Macao, and Israel.

B. Basic Economic Characteristics[20]

Research has shown that there are three main economic characteristics of small economies: high industrial concentration levels, high entry barriers, and suboptimal levels of production. These characteristics result from the basic handicap of small economies—the large size of minimum efficient scales of production or distribution relative to demand.

These unique economic characteristics create a basic tension between productive efficiency and competitive conditions. If a given number of firms can operate efficiently in a market, productive efficiency requires that the market contain only this number of firms—all operating at efficient, productive levels. At the same time, productive efficiency imperatives often cause industrial concentration in small economies to be high enough in many markets to allow market power to be realized. Dynamic efficiency might also be affected by concentration levels and by market power.

In addition, small economies are often characterized by high levels of aggregate concentration in which several large business entities control a large part of the economic activity in the market. Also, their business and political elites are often intertwined.

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[18] GAL, *The Case of New Zealand*, *Supra* note 4.
[19] GAL, SMALL ECONOMIES, *Supra* note 4.
[20] *Id*.

C. Some Implications for Merger Policy[21]

1. General Observations

These facts have significant implications for merger regulation. They imply that **mergers may be necessary in order to achieve efficient scales of production**.[22] In other words, the limited size of domestic demand often prevents firms from reaching minimum efficient scales. Mergers are an important way for firms to grow to such efficient sizes which, in turn, serve to reduce productive inefficiency and sometimes also dynamic inefficiency.[23] Most importantly, mergers are an important tool for the realization of potential efficiencies in oligopolistic markets. In such markets firms might prefer to operate at sub-optimal levels rather than grow internally, in order to not change the status quo significantly (thereby engaging in oligopolistic coordination). Mergers may also be the best-- and sometimes the only-- response of domestic firms to the lowering of trade barriers and the potential entry of more efficient foreign competitors. Finally, domestic firms may need to merge in order to increase their international competitiveness in foreign and international markets.[24] In decision-theory terms, this implies that the costs of false-positive errors are high.

Yet such characteristics often imply that **mergers often significantly increase the market power of the merging parties**. This is because in a small market protected by high entry barriers there might be no actual or potential competitors that could significantly constrain the market power of the merged entity. In decision-theory terms, the costs of false-negative errors are high.

Small size also implies **limited resources**, both human and financial. Even if resources are not limited in relative terms (when controlling for the size of the population), they are often small in absolute terms. Accordingly, even if we assume that the absolute size of the process costs of merger analysis in all economies is similar, the relative impact of such costs on small economies is much more significant in relative terms. For the government, spending scarce resources on merger review implies less funds for other regulatory activities, including cartel and abuse of dominance prohibitions. Such a reduction is especially problematic if these regulatory activities are characterized by economies of scale or learning-by-doing. For private parties, the costs of merger review might be high relative to the benefits to be had from the merger, which might be low in absolute size to begin with, thereby reducing incentives to enter into welfare-enhancing mergers. In decision-theory terms, process costs are high.

Finally, the fact that the business and political elites are often intertwined implies that institutional arrangements have to be made so that the decision maker **should be as independent as possible** from political forces, in order to ensure that the decision is not tainted by narrow political considerations which fail to give sufficient weight to public policy considerations.

These characteristics create a **basic tension between setting rules and standards in merger analysis**. Rules are less costly to apply because determining whether they have been violated is a relatively mechanical process rather than one requiring the exercise of discretion or the

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[21] *Id*.
[22] Scale and scope economies are defined in the attached glossary.
[23] Economic efficiency, and its three basic types, are defined in the attached glossary.
[24] See GAL, SMALL ECONOMIES, *Supra* note 4, at chapter 6.

determination of numerous facts. Process costs are thus reduced. Also, rules facilitate monitoring of the decision makers as the correlation between the rule and the decision is more easily observable, thereby generally increasing motivation to invest time and effort in a correct analysis and reducing errors resulting from political economy influences. On the other hand, the small size of the economy makes it harder to rely on generalizations, given large error costs. This tension plays out in all merger regulatory tools.

The effects of such characteristics on merger policy have been analyzed elsewhere.[25] Such implications include, inter alia, the need to adopt a relatively flexible balancing approach that gives much weight to long-term dynamic considerations and recognizes that high concentration is often a necessary evil in order to achieve efficiency; the need for the illegality test to capture significant increases in both unilateral dominance and oligopolistic coordination; the need to focus on the effects on welfare rather than on protecting competition per se; the inability to rely on rigid structural assumptions as the only or the main element in merger analysis; and the need to recognize that small economies can rarely make a credible threat to prohibit mergers of large, foreign firms even if they significantly affect their economies (and thus they are "effect-takers").[26] Note, that many of these suggestions are applicable to large economies as well, the difference being that the price that small economies would pay for deviations from such rules would be relatively higher, given that in large economies the market's invisible hand has stronger corrective powers in most markets. Since the previous work was published, additional observations have accumulated. Three such observations are analyzed below: the implications of aggregate concentration on merger policy, the importance of dynamic analysis of market conditions, and the practical application of the balancing test. Note that some of these observations are applicable to large economies as well, yet the small size of the market increases the costs of not dealing with them effectively.

2. Aggregate Concentration Concerns[27]

Apart from high concentration levels in many specific markets, small economies often also suffer from high aggregate concentration levels in their economy.[28] Indeed, many if not most small economies are characterized by a small group of economic entities which control a large part of the economic activity through holdings in many markets (hereinafter: "conglomerates"). For example, in Israel the largest 16 conglomerates controlled almost half

[25] *Id*. See also International Competition Network, Special Project for the 8th Annual Conference, Competition Law in Small Economies (2009), p. 30-1, available at: http://www.internationalcompetitionnetwork.org/uploads/library/doc385.pdf
[26] See also Michal S. Gal, *Antitrust in a Globalized Economy: The Unique Enforcement Challenges Faced by Small and Developing Jurisdictions*, 33 FORDHAM INT'L L. J. 101 (2009).
[27] Some parts are based on GAL, SMALL ECONOMIES, *Supra* note 4.
[28] Of course, some large economies suffer from similar problems, such as the Chaebols in Korea, the Keiretzu in Japan and the Business Houses in India. See, e.g., Stijn Claessens, Simeon Djankov, Joseph Fan & Larry Lang, *The Benefits and Costs of Internal Markets: Evidence from East Asia*, 7 EMERGING MARKETS REV. 1(2006); Mara Faccio & Larry Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. OF FIN. ECON. 365 (2002);See Randall Morck, Daniel Wolfenzon & Bernard Yeung, *Corporate Governance, Economic Entrenchment, and Growth*, J. OF ECON. LITERATURE 43(3) 655 (2005) for a survey of studies. There are many reasons for the development of such groups, many of which are not related to size. Yet due to the absolute size and high entry barriers of small economies, the instances of high aggregate concentration levels are often more prominent and more difficult to erode in them.

of the market value of all Israeli firms in 2009.[29] In Hong Kong, the largest 16 conglomerates controlled firms generating 84% of the country's GDP and in Singapore almost 50%.[30] These numbers tell only part of the story, since conglomerates often also control essential markets, including financial institutions and telecommunications.

So- why should we care? As studies performed mostly in the past decade show, high levels of aggregate concentration raise special welfare issues. Conglomerates can create positive effects on the economy. The substantial resources and varied experience of conglomerates, as well as their economies of scale and scope (e.g. distribution, marketing, billing, etc.) often enable them to enter markets more readily than other firms, especially when entry barriers are high. Moreover, their vast financial means and diversified holdings portfolios enable their business units to tap into a larger pool of retained earnings thereby enabling them to take more risk in product development programs or in entry into new markets and increase their ability to overcome short-term financial obstacles. Where governments and market institutions do not function well, conglomerates may allow firms to overcome such obstacles. Most importantly, they may overcome what is known as missing institutions problems arising from inefficient enforcement of contracts and from inefficient external financial markets.[31] Moreover, group reputation substitutes for underdeveloped legal and regulatory mechanisms that leave outside investors vulnerable to exploitation risks and information asymmetries in the market.[32] Conglomerates might also create scale economies in recruitment and in the development of human resources. Accordingly, conglomerates may have positive effects on the competitiveness of firms and markets.[33]

At the same time, however, high levels of aggregate concentration raise significant competitive concerns.[34] Aggregate concentration might increase the instance of oligopolistic coordination in and across markets. Given their current and potential multi-market contact, conglomerates are often likely to create a reciprocal status-quo, thereby not entering each other's market or not engaging in aggressive competition in markets in which they potentially

[29] Tamir Agmon & Ami Tzadik, *Business Groups in Israel* (The Research and Information Center of the Israeli Parliament, 2010).
[30] Stijn Claessens, Simeon Djankov & Larry Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. OF FIN. ECON. 81 (2000). In Singapore the problem is further exacerbated by the f presence of many large and resource-rich Government-Linked Companies. See, e.g., Burton Ong, *The Origins, Objectives and Structure of Competition Law in Singapore*, 29(2) WORLD COMPETITION 269, 272-4 (2006).
[31] See, e.g. Takeo Hoshi, Anil Kashyap & David Scharfstein, Corpotate Structure, Liquidity, and Investment: Evidence from Japanese Industrial Groups, Q. J. OF ECON. 106(1) 33 (1991) ; Tarun Khanna & Krishan Palepu, *The Right Way to Restructure Conglomerates in Emerging Markets*, 77 HARVARD BUS. REV.125 (1999); Yishai Yafeh & Tarun Khanna, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. OF ECON. LITERATURE 331 (2006).
[32] Tarun Khanna & Krishan Palepu, *Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups*, 55(2) J. OF FIN. 867 (2000).
[33] See also Ronald W. Masulis, Peter K. Pham & Jason Zein, *Family Business Groups around the World: Financing Advantages, Control Motivations and Organizational Choices,* 24(11) REV. OF FIN. STUD. 3556 (2011).
[34] I shall not touch here other concerns, such as agency problems resulting from pyramidal holdings which are less relevant to competition concerns, although they enter the welfare analysis. See, e.g., Lucian Aye Bebchuk, Reinir Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 445 (Randell K. Morck ed., 2000); Heitor Almeida & Daniel Wolfenzon, *Should Business Groups be Dismantled? The Equilibrium Costs of Efficient Internal Capital Markets*, 75 J. OF FIN. ECON. 133 (2006).

compete.[35] Conglomerates might also create strong deterrence for the entry or expansion of competitors which are not related to another conglomerate into their markets. For one, conglomerates may find it more profitable to engage in predatory behaviour, because such conduct has wide externalities: it signals to competitors in the many markets in which they operate that the price of competition will be high. These effects, in turn, might lead to stagnation and poor utilization of resources, which negatively affect growth and welfare.[36] A study of the Israeli market, for example, has shown that firms controlled by conglomerates usually had lower growth rates and were less profitable but were more likely to survive than firms not belonging to such conglomerates.[37]

The second major concern is a political economy one: given their size and economic impact, large conglomerates may well attempt- and sometimes succeed- to translate their economic power into political power in order to create, protect and entrench their privileged positions, thereby enjoying benefits such as government protection from the perils of competition in the form of government-erected barriers to the entry and expansion of their rivals. The greater the protection, the larger the profits that can be used for future lobbying. [38]

Moreover, a concentrated economic landscape also implies that lucrative employment opportunities are often quite concentrated in conglomerates, thereby possibly limiting efficient regulation by some regulators seeking future employment opportunities in the private market. Furthermore, often the public is highly affected by such conglomerates, through employment or savings or as suppliers and consumers, a fact which implies that such conglomerates might be considered "too big to fail" and be protected by the government from competitive forces that might erode their power and harm the public in the short-term. The fact that the specific firms in the conglomerate are often tied in mutual guarantee agreements implies that a significant harm to each part of the conglomerate can affect the viability of other parts, thereby creating a domino effect, a fact which might increase governmental protection for any part of the conglomerate. A related concern focuses on the ability of public opinion to limit the welfare-reducing effects of conglomerates. Because of the size of their advertising budgets as well as their political power, their coverage in at least some of the media outlets might be more favourable and not expose all the harm they create to the competitiveness of the economy, thereby reducing the knowledge of the public of such effects which is an essential ingredient in the ability of public opinion to bring about a change in market conditions. Note that such effects may exist regardless of competitive concerns in specific markets,[39] although competition among conglomerates can often significantly reduce such political economy effects.

Competitive forces are further stifled when conglomerates also control major financial institutions. In such situations, it is often harder for new or maverick competitors to get the credit needed to enter or expand in markets which the conglomerate controls or in which a large loan to an existing competitor has been granted. Indeed, a vast literature has shown that

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[35] See, e.g., CONCENTRATED CORPORATE OWNERSHIP (Randell K. Morck ed., 2000).
[36] *Id*; Morck, Wolfenzon & Yeung, *supra* note 28.
[37] Agmon & Tzadik, *supra* note 29.
[38] See, e.g., Morck, Wolfenzon & Yeung, supra note 28.
[39] See, e.g. Lawrence J. White, *What's Been Happening to Aggregate Concentration in the United States? (And Should We Care?)*, N.Y. UNIV., working paper No. EC-02-03 (2001), http://archive.nyu.edu/bitstream/2451/26182/2/2-3.pdf (last visited Oct. 21, 2012).

economic growth requires that savings be directed into value creating investments. Perfect capital markets allocate capital to each investment opportunity until its marginal return equals the market clearing equilibrium interest rate. However, when capital markets are imperfect, inequality reduces investment opportunities, worsens borrowers' incentives, and generates macro-economic volatility.[40] All the factors explored above lead to what is known as the entrenchment problem.

As a result of the above, and as many studies have shown, when aggregate concentration is high **the unit which is relevant for economic analysis is often no longer the freestanding firm, but rather the economic unit of which it is part** through formal (e.g. ownership) and non-formal (e.g. family ties) connections. Indeed, in the past two decades the larger economic unit (referred to in this paper as a conglomerate) has become center stage in finance, corporate governance, innovativeness, competitiveness and other economic analyses. It is time that it start affecting competition law as well, as error costs, especially of false negatives, are high.

How should this affect merger policy? Mergers can potentially strengthen the effects surveyed above. Of course, a merger of two or more conglomerates can significantly increase aggregate concentration levels. But even a merger among firms controlled by such conglomerates may raise anti-competitive concerns by leading to interdependent cooperative conduct between the parties that extends beyond the specific market by placing the parent firms in dangerous proximity to discuss and act jointly on wide aspects of their business and by creating an aura of cooperative team spirit that is apt to dampen competitive intensity between the firms involved. The danger is especially high when the merged entity constitutes a significant part of the business of one or more of the conglomerates, as it should not be expected that parties that share much of their economic interests in one market will compete vigorously as before in another.[41]

The above analysis implies that **mergers should be analyzed through a wider lens**, which takes account not only of the effects of the merger in the specific market, but also its effects on other markets in which the parent or holding companies of the parties to the merger operate. Such effects include, of course, portfolio effects, but may go beyond them to include the effects of aggregate concentration on how the market operates. Indeed, it might be the case that a merger does not have significant effects in the market in which the specific merger takes place, yet significantly affecting the economy. In small economies, in particular, ensuring that the potential self-correcting powers of the market are not further stifled is of special importance. In decision theory terms, the increased process costs from gathering additional information about related firms beyond the current market are justified given the very high error costs resulting from an analysis focused only on the specific market in which the merger takes place.

The wider-lens approach should affect, of course, the analysis of mergers among conglomerates or firms controlled by them, whether or not they have horizontal or vertical

[40] For a survey of the literature see, e.g. Philippe Aghion, Eve Caroli & Cecilia Garcia-Penalosa, *Inequality and Economic Growth: the Perspective of the New Growth Theories*, 34 (7) J. OF ECON. LITERATURE 1615 (1999).
[41] *Decision of the Director of Competition Authority not to Grant an Exemption to Middle East Energy*, Director of Israeli Competition Authority (unpublished, May 13, 1997).

relationships. Unless foreign trade is significantly influential, such mergers should be looked upon with considerable skepticism. Business transactions that may reduce future competition between these large players, even if they increase efficiency in the specific transaction at hand, should be analyzed in a broader perspective, which takes into account the long-term dampening of potential competition between conglomerates that can reduce the degree of contestability in the relevant markets and may even amount to cooperative or collusive behavior, as well as the increase of the additional anti-competitive concerns elaborated above. It is important to emphasize that this policy prescription does not necessarily lead to a complete limitation of conglomerate mergers, especially given economies of scope that such conglomerates can realize, but it does require a much wider analysis of such mergers' effects. This wider-lens analysis is also relevant to the acquisition by a conglomerate of a new firm and even to mergers between firms not belonging to a conglomerate that would allow them to better compete with it.

The special issues raised by conglomerate mergers can be illustrated by the Israeli case of Columbus Capital/Cur Industries.[42] Cur Industries was a large Israeli conglomerate that controlled many firms that held monopoly positions in their respective markets (its firms produced 7% of the Israeli GDP). Columbus Capital was part of the Claridge group, which is an international holdings company with many holdings in the Israeli market, some of which were shared with other conglomerates. Columbus sought to acquire Cur in order to become a major player in the market. The Director of the Israeli competition authority analyzed the effects of the proposed merger both on horizontal competition in markets in which both firms operated, as well as on the potential and existing competition between the merging parties among themselves and with other firms in the market.

The crux of the issue was the effect of the proposed merger on competition among the large conglomerates. In the pre-merger situation (in 1998) three main conglomerates operated in the Israeli market. Given that each of the three controlled a large set of monopolies in markets characterized by high entry barriers that could not be easily overcome by small rivals, the fear of potential competition by other conglomerates was crucial for constraining the strategic decisions of incumbent firms. Any business ties between firms controlled by the conglomerates could potentially reduce their inclination to enter into new markets in which another conglomerate held a dominant position. Accordingly, the Director conditioned his approval of the merger on the severing of all ties of the merged entity with the other large conglomerates and on the merging firms’ agreement to obtain his approval for any future business ties with another conglomerate.

One basic condition for performing such an analysis is that the merger regulation empower the decision-maker to analyze the merger in a wider context so that the analysis is not focused solely on the effects of the merger in the specific market in which the merging parties operate. Unfortunately, not all small jurisdictions meet this condition, and many if not most merger regulations are still based on the traditional concept of the individual firms as the relevant unit in market analysis.[43] The New Zealand Mergers and Acquisitions Guidelines,[44]

[42] *Conditioned Approval of Merger between Columbus Capital Corporation and Cur Industries Ltd.*, Director of Israeli Competition Authority (unpublished, Jan. 5, 1998).
[43] Section 21 of the Israeli Competition Law, 1988, SH No. 1258 p. 128 (Isr.) focuses on effects on the "same market".
[44] Guidelines, Section 10.2

for example, which require an anti-competitive effect "in a market", state that "pure conglomerate acquisitions, which involve the aggregation of businesses operating in markets that are unrelated either horizontally or vertically, are unlikely in themselves to lead to the acquisition of a substantial degree of market power *in a market*, except in unusual circumstances." Such circumstances include cases where the merging parties may share some common features even though they operate in different markets, and thus can be potential entrants into each others' markets. It is interesting to note that, as elaborated below, whereas competition constraints are assessed only with regard to a relevant market, the analysis of benefits from the merger is not limited to any specific market.[45]

Of course, applying merger policy is not without its costs or limitations. One question to ask is whether it can deal effectively with all the issues raised by a conglomerate-dominated market structure. Indeed, other policy tools that go beyond merger policy might also be needed in order to deal with the problems enumerated above as well as others (e.g., when the conglomerates are based on a pyramidal structure which allows the exploitation of shareholders at the lower levels of the pyramid).[46] For example, small economies which suffer from a very high degree of aggregate concentration which stifles competition in their economies should consider making changes to such a structure regardless of merger activity. In Israel, for example, a new legislation was adopted which seeks to create a degree of ownership separation between financial and productive institutions and limit the levels of control in a business pyramid. Furthermore, institutional as well as democratic mandate issues arise: whether the Competition Authority is the proper body to make decisions that affect the economy in many inter-connected ways, and even if so, which considerations should it take into account (e.g., should only competitive issues be taken into account or whether also broader public policy issues that might come under the "public benefit" rubric of some competition laws). These issues, which require further elaboration, are beyond the scope of this paper. Yet it is hoped that this paper will assists in raising awareness to them.

3. Dynamic Analysis of Market Conditions

In small economies in particular it is very easy to **fall into the market share trap**, whereby current market shares serve as strong indicators of the effects of the proposed merger on competition. Indeed, widely-used preliminary indicators of market power such as C4 and HHI are based on market shares. When current market shares are high, as is the case in many mergers in small economies, such indicators might easily lead to a preliminary conclusion that the merger would be harmful to the economy. Yet, especially in small economies a

[45] A note regarding the New Zealand (and Australian) regulatory systems is in place: The Commerce Act prohibits any person from acquiring a firm's assets or shares if that acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market. However, it also allows a person proposing a merger to (voluntarily) seek clearance or authorization from the Commission. The Commission will clear a merger if it is satisfied that the merger will not have, or would not be likely to have, the effect of substantially lessening competition in a New Zealand market; and it will authorize a merger where it is satisfied that the merger will result, or will be likely to result, in such a benefit to the public that it should be permitted even though it is likely to substantially lessen competition. Public benefits are not relevant in a clearance decision; they are relevant in an authorization decision. Such benefits are also not relevant where a merger proceeds without a clearance or an authorization.

[46] For a tax tool see, e.g., Randall Morck, *How to Eliminate Pyramidal Business Groups: The Double Taxation of Intercorporate Dividends and other Incisive Uses of Tax Policy*, 19 NAT'L BUREAU OF ECON. RES. 135 (2005).

dynamic analysis of relevant markets and especially of potential competition is needed in order to realize the real effects of the merger on one's domestic markets. In decision theory terms, the increased process costs from gathering additional information about market conditions beyond current market shares are often justified given the very high error costs resulting from an analysis based mostly on market share analysis.

The recent merger of *Nippon Steel and Sumitomo Metal Industries*. which was analyzed by the Competition Commission of Singapore, serves as a good example.[47] The merger created a steel megalith of the two main foreign main steel pipe and sheet manufacturers that sold their products in Singapore. The market share analysis revealed that the merging parties enjoyed very high joint market shares in many product markets. Yet a dynamic analysis of potential competition revealed that competition in finished steel product markets is regional in nature, and barriers to entry and expansion are low. The merger was thus approved. Indeed, when competition is global or regional, the small economy can benefit from it, provided that there are no significant economies of scale or other obstacles in transaction, transportation, storage, repair or any other aspect of import. Furthermore, the fact that an international firm already supplies some part of the market (even if it is currently a small share) might indicate their constraining power on the local market, since their entry indicates that barriers to entry are not too high to prevent sales in the small economy.

New Zealand is another small economy which also squarely recognizes that when barriers are low, market shares are not a good indicator of the effects of the merger.[48] Rather, the focus should be on dynamics and adjustment costs, as what matters is how fast entry might erode price increases.[49] Accordingly, the New Zealand courts apply a "LET test" for entry: whether entry is Likely, sufficient in Extent, and Timely. Under the LET test, even mergers of firms with current market shares of 100% were approved: The *South Pacific Seeds/Yates* merger is a case in point. The merging parties held 100% of the seed distribution market. Yet a dynamic analysis of market conditions revealed low/moderate barriers to entry and evidence of possible near entrants, which led to the approval of the merger.[50] Accordingly, while the small market size constrains the number of efficiently-sized firms that can operate in the market (competition *in* the market), it does not necessarily constrain competition *for* the market. It is noteworthy that mergers to monopoly are almost never approved in large economies.

Interestingly, the time horizon applied in the case of *New Zealand Bus* for entry is set at three years,[51] which is 50% longer than that set until recently in the US authorities' merger

[47] Proposed Merger between Nippon Steel Corporation ("NSC") and Sumitomo Metal Industries, Ltd (Dec. 21, 2011).
[48] New Zealand Bus Ltd. vs. Commerce Commission (2007), NZCA 502, para. 146.
[49] Dennis W. Carlton, *Why Barriers to Entry Are Barriers to Understanding*, 94(2) AM. ECON. REV. 466 (2004).
[50] South Pacific Seeds PTY Ltd and Yates Ltd, decision 508 (Sep. 25, 2003), http://www.comcom.govt.nz/clearances-register/detail/408 (last visited Oct. 23, 2012); See also MediMedia (ZN) Limited and Adis International, decision 516 (Dec. 18, 2003). The merging parties held a 100% market share in the supply of medicines information to GPs. There were some competition concerns but it was concluded that the pharmaceutical companies and GPs would have countervailing buyer power. http://www.comcom.govt.nz/clearances-register/detail/416 (last visited Oct. 23, 2012).
[51] New Zealand Bus, *supra* note 48, para. 155. It is interesting to note that the case involved the tendering of bus services and so entry can only occur depending on the frequency of the tenders and the contract lead times. It could be argued that entry over a longer period was more relevant in that particular case.

guidelines.[52] This temporal extension is not trivial: given the natural high concentration levels of the economy which are further increased by the merger, the costs imposed on the domestic market from increased market power during this period might be quite significant. Yet a temporal extension may be justified in those cases in which the long-term benefits to the economy from the merger are significant and could not be realized otherwise. Once again, small size may affect the size of these benefits since high degrees of concentration might be necessary for operating efficiently. Two tools are nonetheless suggested in this regard. First, the adoption of a more flexible time horizon, whereby the length of time is not similar in all cases, but rather the length of time increases correlatively with the size of the potential long-term benefits, up to a preset time limit. Singapore' s Merger Guidelines adopt such an approach. The Guidelines state that "Entry within less than two years will generally be timely, but this must be assessed on a case-by-case basis,"[53] thereby leaving the door open for longer periods in special cases. Indeed, it might be possible to read New Zealand cases as reflecting such a flexible facts-based approach to the temporal aspect as well. [54] Second, concessions might be accepted from the merging parties aimed to reduce some of the costs the merger creates in the period before benefits are realized. Interestingly, even large economies have begun to be more flexible in the conduct remedies applied in merger decisions although the rhetoric that "competition law does not engage in sector-specific regulation" still reigns.

4. Balancing Test

As emphasized elsewhere, small economies should adopt a balancing approach for merger regulation.[55] A balancing approach recognizes that a merger should be permitted if the benefits resulting from a merger are greater than it's disadvantage and offset its anti-competitive effects. While balancing is a clear concept in theory, it raises some important practical issues, some of which have been flushed out in decisions of small economies in recent years.

The ultimate test case for a balancing approach is a merger to monopoly. The US Guidelines, which at least in theory adopt a balancing approach, clearly state that "efficiencies almost never justify a merger to monopoly or near- monopoly."[56] Some small economies, however, have taken a different approach. In the recent New Zealand case of *Cavalier Wool Holdings*[57] such a merger was approved. The case raises some interesting issues worth discussing.

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[52] The current 2010 US Horizontal merger guidelines no longer specifies a timeframe for the LET test and is fact-specific. DOJ & FTC Horizontal Merger Guidelines (2010), http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf (last visited Oct. 23, 2012). Section 9.1 state that "entry must be rapid enough to make unprofitable overall the actions causing those effects and thus leading to entry, even though those actions would be profitable until entry takes effect."
[53] CCS Guidelines on The Substantive Assessment of Mergers, para. 7.8 (2007), http://www.ccs.gov.sg/content/dam/ccs/PDFs/CCSGuidelines/substantiveassessmerger_Jul07FINAL.pdf (last visited Oct. 23, 2012).
[54] In *Air New Zealand* the court adopted a two year period. Air New Zealand Limited and Qantas Airways Limited, final determination, para. 242 (Oct. 23, 2003), http://www.comcom.govt.nz/airnewzealandquantas/ (last visited Oct. 23, 2012). While Air New Zealand is an earlier case than New Zealand Bus, they can be read jointly as determining the temporal element based on each case's unique facts.
[55] GAL, SMALL ECONOMIES, *supra* note 4.
[56] U.S. Horizontal Merger Guidelines, *supra* note 52, Section 10.
[57] Cavalier Wool Holdings Limited and New Zealand Wool Services International Limited, decision 725 (June 9, 2011), http://www.comcom.govt.nz/cavalier-wool-holdings-limited-new-zealand-wool-services-international-limited (last visited Oct. 23, 2012). Cavalier was an authorization case, as elaborated in note 45 *supra*.

Cavalier involved a merger of New Zealand's only two wool scouring companies (scouring is the process in which wool clipped from the sheep is cleaned). The High Court rejected the claim that mergers to monopoly require a different standard than other mergers.[58] Several interesting points are worth noting.

Most importantly, are the distributive aspects of the New Zealand approach. Whereas most jurisdictions apply a (wide or narrow) consumer welfare test to merger analysis, New Zealand (as well as Australia) applies a total welfare standard that disregards the locus of benefits, so long as they affect the local economy.[59] Accordingly, a merger will be authorized if the potential public benefits arising from the proposed merger offset its anti-competitive effects. The standard of proof is the civil standard of balance of probabilities. Efficiency considerations are important aspects of "public benefits" and include, inter alia, industrial rationalization resulting from more efficient allocation of resources and from lower production costs and improvement in the quality and safety of goods and services.

The rationale for this approach is expressed in the 1999 Australian Guidelines: "[t]he concept of a benefit to the public is not limited to a benefit to consumers; a benefit to a private party which is of value to the community generally is a public benefit…A merger may result in economies of scale or other resource savings which may not be immediately available to customers in lower prices but may be of benefit to the public as a whole. The community at large has an interest in resource savings, releasing those resources for use elsewhere."[60] Merger policy thus subordinates the welfare of consumers, by way of lower prices, to the long-run productivity of the entire economy. This approach is in line with the view that productivity growth is the most important determinant of long-term consumer welfare and a nation's standard of living.[61] Such considerations gain extra force in a small economy in which the tradeoff between allocative, productive and dynamic efficiency is more pronounced.

Yet, as recognized by the Australian court in *Quantas,*[62] and by the Canadians in *Superior Oil*, such an approach does not necessarily have to be dichotomic- as consumer welfare considerations, including distributive effects, might come into the analysis of public benefits. The weight that should be accorded to cost savings may vary depending upon who takes advantage of them and the time period over which the benefits are received.[63] Indeed, it might be argued that the social uprising in the past several years in countries all around the world strengthens the case for more inclusive growth. The World Bank's recent statements have gone along the same line, based partially on social stability arguments. It should be emphasized that the issue is one not only of pure economics, but also of value judgment. Also, even a total welfare approach does not necessarily have to automatically justify all

[58] *Id*, Sections 107-117.
[59] See, e.g., Air New Zealand, *supra* note 53; the Australian case of Re Qantas Airways Limited [2004] Australian Competition Tribunal 9 Oct. 12, 2004), http://www.austlii.edu.au/au/cases/cth/ACompT/2004/9.html (last visited Oct. 23, 2012).
[60] ACCC Merger Guidelines (1999), sections 6.42 and 6.43. It is noteworthy that in 2007 the power to authorize mergers at first instance was transferred from the ACCC to the Australian Competition Tribunal.
[61] Michael Porter, *Competition and Antitrust: Toward a Productivity-based Approach to Evaluating Mergers and Joint Ventures*, 46 ANTITRUST BULL. 919, 934-35 (2001).
[62] Re Qantas, *supra* note 59, para. 189: "[C]ost savings achieved by a firm in the course of providing goods or services to members of the public are a public benefit which can and should be taken into account for the purposes of s 90 of the Act, where they result in pass through which reduces prices to final consumers, or in other benefits, for example, by way of dividends to a range of shareholders or being returned to the firm for future investment."
[63] *Id*. The Canadian balancing of weights approach seems to go along the same line.

mergers that increase total welfare. Rather, attempts must be made to structure the merger such that consumer welfare will be increased. Only if such changes are highly costly or significantly limit the significant benefits created by the merger, should it be allowed.

In *Cavalier*, the merger eliminated a significant competitive constraint, as it allowed the merger of the only two remaining New Zealand scouring companies. The anti-competitive effects of the merger were significant, as it was estimated that a price increase of at least 5% to 10% would be realized before motivations for new entry would be created. Yet it was concluded that the public benefits outweighed such effects. The public benefits recognized included, inter alia, savings in production and administration costs from the consolidation and rationalization of scouring services that would enable the realization of economies of scale, and the creation of a cost-savings super store for the storage of wool. Rationalization of production was especially important, given the significant decline in wool clip in New Zealand and the development of competition mostly in China.

An interesting question is whether a wide approach should be taken with regard not only to public benefits but also with regard to public detriments. New Zealand Courts have given different answers to this question. In *Telecom* the Court stated in obiter that "[t]he very concept of benefit to the public allows for some netting out...of any detriments to the public from the acquisition itself."[64] This decision refers to a wide concept of net detriments to the public, under which detriments that fall outside the defined markets can offset the positive public benefits claimed. Yet no New Zealand decision has ever viewed net benefits in this wide way. The Commission's approach has been to consider detriments from the lessening of competition in the market(s) in which competition is likely to be lessened, whereas any benefits likely to accrue to the New Zealand public are considered irrespective of the relevant market(s) in which competition is likely to be lessened.[65] A net approach is taken only with regard to the costs in realizing efficiencies.[66] In *Cavalier* the Court left the question open. Yet it would seem that if the goal of the analysis is to benefit the public as a whole, all relevant factors should be taken into account. Otherwise, the analysis is unbalanced.

This approach can be contrasted with that of another small economy, Israel. In the recent case of *Kaniel/Lagin* the majority of the Antitrust Tribunal rejected a merger to monopoly.[67] There, the only two Israeli manufacturers of aluminum cans sought to merge. The firms produced 90% of the cans sold in Israel, while the rest was imported. They argued that the merger was necessary to enable them to increase dynamic efficiency by updating the technology used in producing cans. Following its reading of the Supreme Court cases of *Dor Alon* and *Eurocom*,[68] the Tribunal emphasized that harm to competition is the major test to determine the legality of the merger. Mergers to monopoly would be generally allowed only when no barriers to entry or expansions exist. Efficiency considerations would only be taken into account, if at all, if

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[64] *Telecom Corporation of New Zealand v Commerce Commission* [1992] 3 NZLR 429 (CA)at 528.
[65] Cavalier, *supra* note 56, at Section 64; *New Zealand Bus Ltd v Commerce Commission* [2008] 3 NZLR 433 (CA) at 271.
[66] Cavalier, *supra* note 57, at Section 74. It has been argued that this approach is consistent with the wording of the anti-competitive agreement authorisation provision and the structure of the merger authorisation provision, which requires the Commission to first examine whether a significant lessening of competition is likely before proceeding to an authorization. While this may be true, the criticism expressed in this paper regards the policy level- whether such a system is welfare enhancing.
[67] Competition Case 36014-12-10 Kaniel et al v. Antitrust Authority (June 10, 2012) (Isr).
[68] Civil Appeal 3398/06 Dor Alon et al. v. Director of the Competition Authority (Supreme Court, Des. 6, 2006) (Isr); Civil Appeal 2982/09 Eurocom et at vs. Director of the Competition Authority (Supreme Court, Aug. 20, 2009) (Isr).

they increase consumer welfare. In the case at hand, the production efficiency gains, as large as they may be, would not be translated into lower prices, and thus were deemed to be irrelevant for the analysis. In my view, this approach which gives almost no weight to efficiency considerations is too extreme, as it blocks those mergers that can significantly benefit social welfare.

It is also noteworthy that the New Zealand Commission uses several tools to ensure that the merger will indeed benefit the public. Like many other jurisdictions, benefits should be real rather than pecuniary, must be merger-specific and should not be simple transfers of wealth. Furthermore, the Commission is required to quantify, in so far as possible, detriments and benefits rather than rely on purely intuitive judgment to justify its conclusion that the costs are outweighed by the benefits.[69] Given assessment problems the Commission is not obliged to determine a single figure, but may set a likely range for the quantified effects.[70] Moreover, in *Woolworths* the New Zealand High Court rejected the claim that the probability of all competing counterfactuals should be weighed in order to assess the effects on competition.[71] Instead, the competition effects of the worst case are assessed. These tools create a higher level of certainty that indeed benefits would outweigh detriments.

Chapter III: Merger Policy for Micro-Economies

What happens when you take these traits of small economies to the extreme? This is the question micro-economies pose. Does an extremely small size of one's domestic market strengthen the need for a merger policy or is there no justification for an investment in such a policy? And even if such a justification exists, how should the law be affected, if at all? These questions, which to my knowledge have not as of yet been explored in depth in the literature, are the focus of the analysis below.

A. Definition of micro-economies

Micro-economies have not, as of yet, been defined for competition law purposes. Several institutions define groups that include also micro economies, but often the defining parameters are chosen to serve another purpose. For example, the WTO defines a group of "small, vulnerable economies" based, inter alia, on their very low share of world merchandise trade (no more than 0.16 per cent).[72] This definition may serve well the WTO for trade purposes, since it exemplifies the limited trade effects and negotiating power such jurisdictions have in world trade circles. Yet it captures a wide array of countries, some of which do not have a small domestic population (such as Cuba with a population of approximately 11M), and thus is a better indicator of the level of market development and its openness to trade rather than its size for competition law purposes.

We define a micro-economy as a sovereign economy[73] which (1) has a population of up to 200,000 and (2) is not economically immersed into a large jurisdiction. This population

[69] Cavalier, *supra* note 57, Sections 91-106.
[70] *Id*., Section 105.
[71] Commerce Commission v. Woolworths New Zealand Ltd [2008] NZCA 276, Sections 120-1.
[72] World Trade Organization, http://www.wto.org/english/thewto_e/minist_e/min11_e/brief_svc_e.htm (last visited Oct. 23, 2012). Additional parameters include their shares of agricultural and non-agricultural products.
[73] Including political dependencies, so long as they are self-governing and thus adopt and enforce their own laws. For example, Jersey and Guernsey are British Crown Dependencies. Greenland is a self-

threshold barely meets the suggested population threshold for one competition law administrator.[74] It is random in the sense that those jurisdictions that almost meet the threshold may have similar characteristics, but it is nonetheless a rough and useful indicator of the characteristics noted below. Several sub-groups can be identified, including miniscule economies (e.g., Nauru and Tuvalu with a population of about 10,000). While these are undoubtedly micro-economies, they require a different analysis and most of the recommendations below do not apply to them. Most importantly, there is no justification for them to invest in a merger law. Indeed, the empirical findings show that no miniscule economy has adopted such a law.[75] Accordingly, all jurisdictions below a threshold of 50,000 are exempted from the analysis below with a strong recommendation to join a regional agreement with competition law arrangements, as many have already done.[76] The second condition, which requires that the jurisdiction not be economically immersed into a large one, is designed to ensure that political boundaries are relevant for the economic analysis which stands at the basis of competition law. Accordingly, jurisdictions such as Andorra, Lichtenstein and San Marino do not fit the definition despite their very small population. Such jurisdictions can often rely, to a large extent, on positive externalities from competition law enforcement in the large jurisdiction of which they are part.

We identify twenty-three jurisdictions that meet this definition (excluding miniscule economies), which are listed in Table A annexed to this paper.[77] Most are located either in the Caribbean region (e.g., Antigua and Barbuda, St. Vincent and the Grenadines, St Lucia, Curacao) and East Asia and the Pacific (e.g., Kiribatii, Marshall Islands, Micronesia). Almost all are island economies. Micro economies that are not islands are usually economically immersed into their large neighboring economies and thus do not fit the definition. While some micro-states are high-income countries (e.g., Jersey, Greenland, Guernsey), most are low-middle income countries. [78] Yet it is important to emphasize that the level of income, or the stage of development, is not an integral part of the definition. Rather, the focus is only on the extremely small size of the domestic market and thus captures both developing and developed economies. Of course, the development stage might nonetheless affect optimal law. While this issue is beyond the scope of this paper,[79] two observations are offered. Most importantly, competition law is a second-tier law, to be adopted only when other, more basic laws are in place and are enforced (e.g. property and contract law). Moreover, even within competition law, the regulation of anti-competitive agreements and abusive conduct by dominant firms is often rightly perceived to be a more important investment than merger

governing overseas administrative division of Denmark. This definition is in line with the approach taken by the OECD: *Small Economies and Competition Policy: A Background Paper*, OECD Global Forum on Competition 6 (Feb. 7, 2003). See also Charles Webb, *Multum In Parvo: Competition Law in Small Economies Compared*, THE JERSEY L. REV. 315 (2006).

[74] Abel Mateus estimates that, to function effectively, an agency requires around five to seven professionals per million of population. Abel M. Mateus, *Competition and Development: What Competition Law Regime*? (2010), manuscript available at: http://ssrn.com/abstract=1699643 (last visited Oct. 23, 2012).

[75] Faroe Islands, which has a merger law, is very close to the threshold.

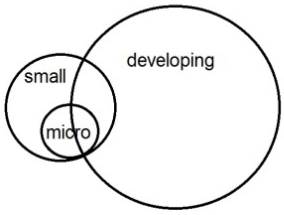
[76] For a full list see Table A in the appendix.

[77] *Id*.

[78] The World Bank, http://data.worldbank.org/income-level/ (last visited Oct. 23, 2012).

[79] For exploration of the effect of development on optimal competition law see, e.g., Gal, *When the Going Gets Tight*, supra note 2; OECD, *Cross-Border Merger Control: Challenges for Developing and Emerging Economies* (2011), http://www.oecd.org/daf/competition/mergers/50114086.pdf (last visited Oct. 23, 2012).

control. Accordingly, quite a few small, developing economies that adopted the other two legs of competition law, did not adopt merger control. Second, the higher the GDP, the less competition law enforcement affects the ability to finance other regulatory functions. Accordingly, it should come as no surprise that those micro-economies with a functional competition law are generally high income economies (Greenland, Guernsey, Jersey, Faroe Island, US Virgin Island). It is also noteworthy that another strong correlation is found between the fact that a micro-economy is a political dependency of a large jurisdiction and the fact that it has a competition law (Greenland, Faroe Island, US Virgin Island). Often their laws strongly resemble those of the large jurisdiction, even if it is not cost-effective to apply such a law.



Drawing 1: How definitions relate to each other

It is noteworthy that the United Nations' definition of Small Island Developing States (SIDS) captures many of the jurisdictions that come under the definition of micro-states suggested above. SIDS are defined by the UN as a "distinct group of developing countries facing specific social, economic and environmental vulnerabilities,"[80] including a narrow resource base depriving them of the benefits of economies of scale, small domestic markets and heavy dependence on a few external and remote markets. Currently, the UN lists 52 SIDS.[81] The UN definition was designed to capture those jurisdictions which are highly disadvantaged in their development process due to size and remoteness which require special support from the international community. It thus does not capture all the micro-economies for competition law purposes and leaves outside those jurisdictions which are not islands or are not developing. Furthermore, its definition of smallness is vague and quite wide, as countries like Cuba, with a population of approximately 11 million, are included.

B. Basic economic traits[82]

The most important characteristic of micro economies is, of course, their extremely small domestic demand. Given that they are not economically immersed into a large jurisdiction, almost all markets are **highly concentrated**, with a very small number of players operating in them. High concentration is often needed in order to produce efficiently.

[80] Small Island Developing States: Small Islands Big(ger) Stakes, p. 2, http://www.unohrlls.org/UserFiles/File/UN_SIDS_booklet_5x6-5_062811_web.pdf (last visited Oct. 23, 2012).
[81] list: UN-OHALLS, http://www.unohrlls.org/en/sids/44/ (last visited Oct. 23, 2012).
[82] Builds mostly on the Commonwealth Secretariat and a World Bank Joint Task Force, *Small States: Meeting Challenges in the Global Economy* (2000), http://siteresources.worldbank.org/PROJECTS/Resources/meetingchallengeinglobaleconomyl.pdf (last visited Oct. 23, 2012) (hereafter: Task Force). For some of the most important research on SIDS see, Lino Briguglio, *Small Island Developing States and Their Economic Vulnerabilities*, 23(9) WORLD DEV. 1615 (1995).

In addition, micro-economies suffer from quite **high transport costs** from their major trading partners. The main reason for this is that almost all are islands economies and are therefore constrained to the use of air and sea transport for imports and exports. Where a micro economy is an archipelago, transportation costs might be high even between internal markets. This problem is exacerbated by the fact that many micro-states are off the major sea and air transport routes. Finally, micro economies tend to require relatively small and fragmented cargoes, leading to high per unit costs. When transport is infrequent and/or irregular, a related **cost of keeping large stocks** is created, which results from tied up capital and warehousing. [83]

These two factors, in turn, imply that **entry barriers** into markets are generally high and that potential competition from foreign entrants is also often limited, even when a liberal trade policy is adopted.

Studies have shown that these basic characteristics often create several economic effects which pose special development challenges.[84] Most micro economies concentrate production and exports on one or two major industries (e.g. sugar, tourism, oil, banking) and thus depend on a narrow range of products.[85] This **limited diversification** is often the only way that such economies can realize economies of scale and create international tradable goods.[86] Yet such concentration of production also means that they are significantly **vulnerable to external shocks** such as events in global markets, changes in the global trade patterns, natural disasters and environmental changes, over which they have little if any influence and which cause high volatility in national incomes.[87] Indeed, many micro economies are in regions susceptible to natural disasters such as hurricanes, cyclones, drought and volcanic eruptions. Furthermore, almost all micro-economies have negligible control on the prices of the products they export and import (price-takers). This also renders them very exposed to what happens in the rest of the world.[88] Since most of the adverse events affect the entire population, risk pooling at the national level is not feasible.[89]

It is interesting to note, however, that some jurisdictions have **successfully used their smallness to their advantage**. To explain this observation, let us start from the premise that in some industries consumer choice is based, to a large extent, on the strength of a commitment to ensure that the consumers' long-term interests will not be harmed. The banking industry serves as an example. Secrecy of transactions may be especially important to some consumers. A micro-economy which specializes in banking might be able to use its small size as a commitment device to do all in its power to protect such secrecy: otherwise it might significantly harm the main industry on which its economy is based. Accordingly, the

[83] *Id*, Task Force.
[84] *Id*.
[85] Briguglio, *supra* note 82.
[86] D. Worrell, "Economic Policies in Small Open Economies: Prospects for the Caribbean, Economic Paper No. 23 (London: Commonwealth Secretariat. 1992), p. 9-10.
[87] Briguglio, supra note 82; Christopher D. Easter, “A Commonwealth Vulnerability Index for Developing Countries: The Position of Small States,” The Round Table: The Commonwealth Journal of International Affairs 351 (1999).
[88] Task Force, *supra* note 82.
[89]*Id*.

vulnerability of the economy aligns consumer preferences with those of the micro economy, and strengthens the credibility of its commitment to its consumers.[90]

As a result of limited demand coupled with limited production capabilities, **many of the products are produced elsewhere** and are imported into the micro economy. Interestingly, part of the demand for imports is based on changes in traditional consumption patterns which were often designed to take account of production capabilities. As consumption patterns converge with those of large, developed countries, traditional economic activities and the structures that support them become less capable of meeting social needs.[91]

Micro economies also face **significant diseconomies of scale in providing public services**, as often they do not have sufficient institutional capacity to perform basic governmental functions. At the same time, the size of government spending is often very large relative to the size of the economy.

C. Some implications for merger policy

These economic characteristics bring to an extreme many of the traits of small economies- from the fact that a merger might often be the only way to realize economies of scale, to the fact that given extremely limited governmental resources, investing in merger regulation often implies that other regulatory tasks- whether within the competition law realm or in other areas of governmental action- would not be performed. Accordingly, below we analyze some of the effects of such traits on merger policy.

1. Rationales for Merger Regulation

The first question to be asked is whether micro-economies can justify the adoption of merger regulation. In a perfect world, without enforcement and compliance costs, the answer would be an unqualified yes. Yet in the real world a positive answer is far from trivial, given the costs imposed on the merging parties as well as on the government. As elaborated below, often the answer is not a dichotomic yes or no, but rather depends on the way that the merger regulation is structured, both substantively and procedurally, in order to create a cost-effective regime. The effect of micro-size is to mandate the jurisdiction to not take anything (e.g., rationales for regulation, substantive rules or institutional arrangements) for granted.

Let us first raise some of the argument for a (significantly truncated) merger policy. First, preventing certain changes in market structure from their incipiency is especially important for micro economies because **market power, once created, is very difficult to erode** due to the extremely limited self-correcting powers of the market's invisible hand.

Second, **some industries have a very large impact on the economy**. This is because the economies of micro-economies are generally based on one or two major products. In addition, some markets create bottlenecks for many other markets (e.g. transportation services into an island economy, telecommunications services or warehousing). Structural changes in such markets might significantly affect social welfare.

[90] On the other hand, however, they might be more vulnerable to external pressures.
[91] Task Force, *supra* note 82.

The Jersey case of the *Ferryspeed/CHannel Express* merger serves as a good example.[92] The JCRA found that the merger would significantly limit competition in the market for seaborne temperature-controlled freight services between Jersey and the UK, which was a major way for importing many products into the island. The main reason was the further concentration of suitable warehouse space in Jersey's harbor that would result from the merger, which created a significant barrier for competition. The JCRA thus refused to approve the merger, as proposed. In response, the parties restructured their agreement, whereby the warehouse that belonged to one of the merging parties was sold to a third party freight operator. This restructuring provided the new entrant with a key asset necessary to compete in the market.

Third, the need to adopt a Merger Regulation is strengthened by the fact that **other competition law tools might be difficult to apply** in order to limit the market power created or strengthened by a merger (e.g. oligopolistic coordination, which is the Achilles' heel of competition law, is much more prevalent in such economies). These three considerations imply that the costs of false-negative errors in merger analysis in micro economies are high.

At the same time, since merger regulation carries enforcement costs, both for the merging parties as well as for the regulator, it might not be cost-effective to engage in such regulation, at least not in a large part of the cases. Several features of micro-economies affect regulatory costs. First, **the size of the market does not necessarily affect the absolute size of the "fixed" costs of merger review-** collecting the relevant facts and analyzing their effect on the market. Such costs are incurred regardless of the size of the economy, because the analytical steps of a merger analysis are similar in markets of all sizes. It may thus not be economically justified to regulate some mergers, or at least to spend large resources to analyze them.

Second, the micro-size of the economy implies that **the effects of many mergers --in *absolute financial terms*-- would be minimal, even if such effects might be high in relative terms.** To give an example, assume that two distributors compete in the market for radios. Further assume that each sells 500 radios a year, for a profit of 2,000 Euros. If these two firms merge, their joint profit will rise to 5,000 due to their joint market power. This implies a significant increase in their joint profit (1000, an increase of more than 20%). Yet in absolute terms, the increase in the costs of radios as a result of the merger will have quite a minimal effect on consumers. Even over a period of five years-- longer than that considered in most merger analyses around the world-- the cost effect of the merger in absolute terms is small (1,000*5=5,000). In decision-theoretic terminology, the two considerations just explored indicate that process costs of Merger Regulation in micro-economies are high.

Third, **even a small regulatory burden (in absolute size) might limit incentives to enter into some welfare-enhancing mergers**. Since the profits to be had in a micro-economy's markets are quite small, the costs a firm will be willing to invest in the merger process will also generally be quite small. Accordingly, as many domestic firms may already be suffering from high costs due to the limited scales of operation, imposing upon them high merger review burdens might be harmful to the economy. Further harm can result if some of the parties to a potential merger will exit the market, thereby creating a situation that can be even worse compared to what would have occurred had the merger taken place.

[92] JCRA, Decision M 005/05 Ferryspeed (C.I.) Ltd./Channel Express (C.I.) Ltd. (2005) http://www.jcra.je/pdf/060711%20final%20public%20version%20decision%20ferryspeed.pdf (last visited Oct. 23, 2012).

Fourth, given extremely limited competitive conditions in most markets (especially where oligopolistic coordination is already strong), the effect of the merger on market conditions might sometimes be small. Fifth, **many of the firms which affect micro-economies are located elsewhere** and are often subject to the merger regulations of large jurisdictions, an issue we shall elaborate upon below. In decision-theoretic terminology, these last three considerations indicate that the benefits of merger regulation in micro-economies can be quite low in some types of mergers.

Finally, **many mergers may be necessary in order to achieve efficient scales of production**. Mergers are an important way of firms to grow to such efficient sizes and to compete with foreign competitors in local markets (as well as foreign markets). Accordingly, a large number of mergers would most likely be justified, despite the increase they create in concentration levels. In decision-theoretic terminology, the costs of false-positive errors can be quite high.

These costs do not imply, however, that micro-economies should never adopt a merger regulation. Rather, they imply that the regulation should be carefully structured so as to take into account the special characteristics of the economy in order to ensure that regulatory interference in the market is, indeed, cost-effective and efficient. Accordingly, the following discussion suggests some tools to structure merger policy in a cost-effective manner.

2. Potential (Partial) Institutional Solutions

We begin the analysis with potential institutional solutions, rather than with substantive rules. This is because if a way cannot be found to make merger regulation cost effective, then even the best substantive rules for balancing allocative, productive and dynamic efficiency considerations would be futile and harmful. Accordingly, this section briefly reviews three potential (yet partial) and potentially cumulative institutional solutions, to be considered by micro-economies.

The first partial solution is to **join forces with neighboring jurisdictions** which might be affected by similar institutional limitations or by the same mergers. Indeed, it is not surprising that many micro-economies have entered into regional competition law enforcement agreements (RJCAs) with neighboring jurisdictions.[93] As elaborated elsewhere, RJCAs enable jurisdictions to pool together scarce resources to reach economies of scale in enforcement activities (investigations, enforcement), as well as in competition advocacy and training.[94] In some situations RJCAs may provide the only viable solution for enforcement, given severe resource constraints. The Organization of Eastern Caribbean States (OECS) provides such an example: it is comprised of Caribbean developing micro-economies, such as Montserrat with a population of about 5,000 and St Kitts with a population of about 50,000. Each alone cannot justify an investment in a competition law. Yet by pooling their resources they are able to create a joint competition authority that deals with competition law issues that affect them.[95] RJCAs also serve to solve enforcement capability constraints, especially with

[93] See Table A in the appendix.
[94] Michal S. Gal, "Regional Agreements: An Important Step in International Antitrust" 60 *U. of Toronto L. J.* 239-61 (2010); Michal S. Gal and Inbal Wassmer- Faibish, "Regional Competition Law Agreements: Has the Potential been Realized?" in *Regional Competition Law Agreements* (Bakhum et al. eds., Edgar Elgar, 2012).
[95] Yet the OECS, as well as the CARICOM agreement which applies in the region, do not, as of yet, provide for a supranational merger regulation. Revised Treaty Of Chaguaramas Establishing The

regard to multinational issues (e.g., evidence gathering, creating a credible threat to prohibit the merger of a foreign firm, and overcoming deep-rooted limitations of existing authorities, including corruption, inefficiency and bureaucratic obstacles). It should be noted, however, that despite their great potential, empirical studies indicate that most RJCAs do not as of yet work efficiently.[96] Yet one example of an RJCA that does work can be found in the joint enforcement agreement between the two micro-economies Guernsey and Jersey, which have reached the conclusion that given the large similarity of their markets and their close geographic proximity, as well as their limited enforcement resources, a joint merger regulation is justified in order to limit duplicative enforcement resources and increase their ability to deal with anti-competitive conduct.[97] An additional example involves Liechtenstein,[98] which does not have its own competition law but competition law applies in it through its membership in the European Economic Area. Investigations of violations that affect EU member states are conducted by the European Free Trade Area Surveillance Authority.[99]

The second partial solution is to **combine regulatory functions.** Competition law and direct regulation are the immediate candidates, since they share some commonalities. Generally speaking, they both attempt to regulate market conditions in order to increase social welfare. The basic idea is that , in some markets serious obstacles to the well-functioning of the market's invisible hand exist (natural in the case of direct regulation or artificial in the case of competition law), which should be mitigated by some level of intervention. Some of the methods they use to determine whether regulation is required are also similar: both require analysis of market failure and competitive conditions as well as how a remedy would affect conditions in the market. Yet they are generally based on different assumptions and involve different tools. Direct regulation is based on the assumption that the market suffers from an inherent natural market failure. The regulator is thus often empowered to intervene directly in the market and set market conditions ex ante in such a way that would micro-manage the economic environment and reduce the effects of the market failure. Competition law is based on a somewhat opposite assumption: that the market's invisible hand will generally work well, if firms are prohibited from erecting artificial barriers to competition and thus intervention is minimal and geared towards preventing such obstacles.

In light of the above, in most jurisdictions the sector-specific regulator and the competition authority are separate bodies.[100] Yet in micro-economies it may make sense to integrate both functions. Beyond the serious regulatory resource limitations issues, the economic analysis of market conditions might in many cases be relatively similar given highly concentrated market structures. Furthermore, in a micro-economy remedies might need to be more interventionary

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Caribbean Community Including The CARICOM Single Market And Economy, article 169 (2001), http://www.caricom.org/jsp/community/revised_treaty-text.pdf (last visited Oct. 23, 2012). Similarly, the Pacific Islands Forum, which is comprised, inter alia, of quite a few micro-economies, is considering a model competition law, including merger control, for countries in the region. Yet the cost of administration and enforcement is at issue.

[96] GAL, SMALL ECONOMIES, *supra* note 4.

[97] The Channel Islands Competition and Regulatory Authorities (CICRA), http://www.cicra.gg/ (last visited Oct. 23, 2012). Approval from CICRA must be obtained before certain mergers or acquisitions are executed.

[98] Note that Lichtenstein does not meet our definition of a micro-economy because it is integrated into a larger market.

[99] EFTA Surveillance Authority, www.eftasurv.int/fieldsofwork/fieldcompetition/

[100] For an exception see the ACCC, http://www.accc.gov.au/ (last visited Oct. 23, 2012).

than in large economies. Accordingly, Guernsey, for example, has adopted a model in which the competition and regulatory functions are integrated into the same body. Yet, to the degree possible, there is merit in ensuring some degree of structural separation between the two functions.

The third partial solution is to **make use of technical assistance** in important merger cases. Today some competition authorities and international institutions offer technical assistance in applying one's competition law, to assist in overcoming severe enforcement limitations.[101] Of course, technical assistance cannot be used in all mergers, but it can be used for analyzing those unique and complex mergers that have significant effects on the economy.

3. Cost-effective Substantive and Procedural Rules

Whether all, either, or neither above institutional solutions are adopted, the traits of a micro economy mandate that it adopt a **very limited merger regulation**, which aims to target only those mergers that can both create significant harm to the micro-economy and that can practically be challenged in a cost-effective manner. As elaborated below, this does not mean a simple bare-bone regulation, but rather a careful design of regulatory tools to fit the economy's needs in accordance with decision theory principles. This sub-chapter includes some suggestions.

A. What does not change?

Let me start with the observation that even micro-size does not affect some parts of merger regulation. For example, **defining what type of transaction constitutes a merger.** There is no reason that requires a micro-economy to take its own path rather than follow the definitions adopted by other jurisdictions, as long as such definitions are efficiently structured. Such a definition should include acquisitions that enable one entity to exercise de facto "decisive influence" over another, as well as major asset transactions.

Another example involves the **illegality test** which sets the standard against which the anti-competitive effects of the merger will be evaluated. The "Substantial Lessening of Competition" (SLC) test, which is used by most jurisdictions around the world, is also fit for a micro-economy. Most importantly, it is sufficiently wide to capture both unilateral and cooperative anti-competitive effects which might be created by mergers. This point is exemplified by the Swiss experience, in which a dominance tests, which was interpreted as a super-dominance standard, has led to a too-lenient merger policy, not capable of prohibiting

[101] See, e.g., ICN, Assessing Technical Assistance: Preliminary Results (2005); Daniel D. Sokol and Kyle Stiegert, "An Empirical Evaluation of Long Term Advisors and Short Term Interventions in Technical Assistance and Capacity Building" (2008), available at: http://www.coleurope.eu/content/gclc/documents/GCLC%20WP%2002-08.pdf

many mergers that significantly affect competition in their markets.[102] Unfortunately some micro economies, such as the Faroe Islands, also apply a dominance test.[103]

One point should nonetheless be emphasized with regard to Micro-economies: The central core of the illegality test is a comparison of the prospects for competition with and without the merger (the counterfactual). In many cases the counterfactual might indicate a low degree of competition in the market, even if the merger was not prohibited, due to the interdependence among market players. This limited competition should be taken as a given and serve as the benchmark, unless a foreseeable change in market conditions would change its competitiveness.

B. Limiting Application to Domestic Firms

Regulation should be limited to those mergers that create a strong presumption of significant anti-competitive effects, in both relative and absolute terms.

One bold suggestion is to **create a short list of markets or firms** to which the merger regulation will apply. Mergers in all other areas of the economy will not be regulated. Such a list should be based on a pure economic criterion: the potential significant effects of further concentration in the specific industry on social welfare. Most importantly, mergers in the main production or consumption markets of the economy and those in strategic markets that have a significant domino effect on other markets should be included in the list. Those include, *inter alia,* transportation services and storage facilities for goods imported. This is because such markets create bottlenecks in the flow of traded goods in and out of the economy and thus determine, to a large extent, the degree of competition. The competitiveness of passenger transportation is also important, since the fact that passengers can self-import products into the island also creates competitive pressures. It is noteworthy that even if at the time that the merger regulation is adopted no competition exists in these markets, it may still be justified to include them on the list, since market structures can change over time. Firms in listed markets should be required to notify the authority and receive its approval before they merge.

In adopting such a method, however, two factors should be considered. First, as market conditions change over time, the maintenance of the list might require updated studies of market conditions in relevant sectors. The second involves political economy considerations. Once firms can potentially be exempted from regulation, it is expected that some firms -- especially those with economic power which might translate into political power-- will attempt to influence the regulator to grant them an exemption (political capture). This might be a real problem in a micro economy in which political and business elites are often intertwined. A partial solution involves requiring the regulator to clearly state the economic grounds for the exemption and the date it will be reviewed again, or subjecting his decision to an impartial judicial body.

Should the list option not be adopted, merger regulation can also be limited by using thresholds. Here I suggest a combination of the **following three methods**. First, thresholds should be set narrowly. Second, the threshold requirements should change in accordance with

[102] See Samuel Rutz, *Applying the Theory of Small Economies and Competition Policy: The Case of Switzerland*, Secretariat of the Swiss Competition Commission, chapter 4 (2010).
[103] Faroe Competition Act No. 35, section 15(1) (May 3, 2007).

the type of the merger (horizontal, vertical or conglomerate). Third, thresholds for some special industries should be set at lower levels. These suggestions are elaborated below.

Thresholds should serve as a *de minimis* rule, which attempts to shun out those mergers with minimal effects on the a micro-economy economy. I suggest that the threshold be set at a level which is based on the assumption that even if profits are increased by 20% or so, then the absolute effect of the merger will still be negligible and would not merit review, as the example of the merger of the two radio distributors above indicated.

Turnovers should generally relate to turnovers in *the micro economy* rather than to worldwide turnovers. This is because the latter do not have an immediate effect on competitive conditions in the micro economy. The newly revised Guidelines on Merger Procedures of Singapore[104] help explain this point. The Guidelines state that the Competition Commission of Singapore is unlikely to investigate a merger if the "turnover in Singapore in the financial year preceding the transaction of each of the parties [is] below S$5 million, and a combined worldwide turnover in the financial year preceding the transaction of all of the parties [is] below S$50 million." In Singapore, where notification of all mergers is voluntary, and the authority has more power than a micro economy to impose merger conditions, these guidelines serve as a crude safe-harbour self-assessment tool. Yet in a micro-economy and especially one in which notification is mandatory, such thresholds might be problematic. A local turnover requirement is self-evident. But a worldwide turnover is not. Assume that the merging parties' domestic trade in is negligible, but they are major players in foreign markets- why would it harm the micro economy? Indeed, the opposite can be argued: given the current situation, in which each jurisdiction takes into account the effects of a conduct on its own welfare and disregards the externalities that regulating such conduct create on the rest of the world, a merger between domestic firms can limit competition among them in foreign markets, thereby increasing their revenues and potentially benefitting the local economy.[105] If at all, a large worldwide turnover should serve to exempt the merger of foreign firms, at least from notification, as elaborated below.

It might also make sense to require different turnover thresholds for different types of mergers, as many economies do.[106] Horizontal mergers raise the strongest concerns for merger policy. Thresholds for such mergers should thus be set at a lower level than those for vertical mergers. Conglomerate mergers should be required to meet the most lenient threshold, unless aggregate concentration is high and the merger involves at least one of the large business entities, as elaborated above. Of course, a merger that comes under two or more categories must meet all relevant thresholds.

Some jurisdictions use also market share threshold. There is no simple answer as to how high (or low) concentration measures need to be to prompt (or dismiss) concerns about the impact of a merger on competition. Setting the market share threshold is a difficult task, since it should capture both unilateral and cooperative effects on competition. The threshold should not be set too low. Especially in a micro economy, a low threshold implies that almost all

[104] CCS Guidelines on Merger Procedures (July 1, 2012), http://malaysianlaw.my/attachments/CCS%20Guidelines%20on%20Merger%20Procedures%202012_72436.pdf (last visited Oct. 23, 2012).
[105] For a decision along those lines see, *e.g.*, Director of the Israeli Competition Authority, Waiver from Approval of Restrictive Agreement, Elisra and Elta (unpublished decision).
[106] See the Competition (Mergers and Acquisitions) (Jersey) Order (2010).

mergers would be captured by the regulation, as firms generally must provide large market shares in order to operate at minimum efficient scales. Jersey, for example, has adopted a market share of 20-25% as a benchmark.[107] This threshold is much too low. It implies that a merger that allows five or four equal firms to operate in the market should be caught under the regulation because its likely anti-competitive effects will outweigh its pro-competitive ones. This is a problematic assumption to make in a micro-economy. The market share should be set at a much higher level, which assumes that most mergers among competitors in small markets will be justified by the need to operate at efficient levels of production. Seychelles, for example, has set the threshold at 40% market share.[108]

It is also suggested that thresholds in some strategic or main industries be set at lower or higher levels, depending on the industry.[109] This suggestion is based on the same logic as the list suggestion above.

C. Extra-territorial Reach of the Law

Extra-territorial mergers may affect a micro-economy significantly. It might be the case that two or more foreign firms which actually or potentially compete in a micro-economy's market, decide to merge. For example, assume that the only two tire manufacturers whose tires are sold in a micro-economy wish to merge. Both are foreign companies which sell their products through local distributors. This raises the question of whether such mergers ought to be regulated by the micro-economy and if so, under which legal doctrines. The question is important, inter alia, because of increased cross-border merger activity, which has increased nine-fold in real value terms as well as in terms of numbers over the period of 1987–2007, and the fact that in value terms most of such mergers (88%) were between firms located in developed jurisdictions.[110]

On a normative level, it is relatively easy to devise legal tools in order to capture such mergers under the regulation. The "effects doctrine" or the "implementation test" might apply in a micro-economy through customary public international law.[111] But even if it does not, the Merger Regulation can clearly state that it has an extra-territorial reach, like many other jurisdictions do.

Yet such regulation raises serious practical problems. First, international firms may not have any assets in a micro-economy. Their products might be traded through local distributors. It might thus be difficult to impose a remedy in such a setting. Second, and more importantly,

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[107] Competition (Mergers and Acquisitions) (Jersey) Order (2005).
[108] Seychelles Fair Competition Act, Section 21 (2009), http://www.ftc.sc/index.php?option=com_content&view=article&id=49&Itemid=57 (last visited Oct. 23, 2012). For a similar threshold see Singapore, CCS Guidelines on Merger Procedures, *supra* note 104, para. 3.6.
[109] For Example, , In Guernsey, where an acquiring business in a prospective merger or acquisition that meets the thresholds is a credit or financial institution, it should, in the first instance, submit a Shortened Merger Application Form to allow us to undertake a preliminary review of the transaction. The Competition (Prescribed Mergers and Acquisitions) (Guernsey) Regulations (2012) . This is because the low threshold that applies to most markets is not relevant to the financial industry, which is the main industry on the island.
[110] United Nations Conference on Trade and Development, http://stats.unctad.org/FDI (last visited Oct. 23, 2012).
[111] For extraterritoriality see, for example, Maher M. Dabbah, International and Comparative Competition Law (Cambridge, 2010), chapter 8.

generally sales in a micro-economy comprise a small fraction of the international firms' total revenues. Accordingly, a micro-economy's merger authority would most likely not be able to prevent a merger from occurring. This is a problem in all small and micro economies. Were the jurisdiction to place significant regulatory burdens on the merger, the foreign firm would, most likely, choose to exit the economy and not trade in it.[112] The negative welfare effects of the exit of the foreign firm from the micro economy, however, may well be greater than the welfare effects from the continued operation of the merged entity within its borders. Accordingly, a micro economy cannot create a "credible threat" to block the merger. The foreign firm, acknowledging this effect, will not take into account, in its merger decision, the effect of its decision on the micro economy.[113] Indeed, studies have empirically shown that small and micro economies generally do not challenge the mergers of large international firms.[114] Accordingly the micro-economy should take these mergers as given. This implies that it will generally not be cost-effective to regulate such mergers. Otherwise, the Authority might find itself spending a large part of its resources on reviewing mergers with no effective remedies at hand.

At the same time, however, given the significant effects some of these mergers impose on the micro economies, regulation is justified when imposing remedies to limit the negative effects of the merger is practical and economically justified. Such remedies are based on the assumption that mergers between foreign firms will take place regardless of the effects of the merger on the micro-economy and instead attempt to regulate the merged entities with regard to their actions in the micro-economy.[115] For example, if the two only airlines that compete on flying to the micro-economy merge, the merger might be conditioned on a commitment not to reduce the number of flights.

Accordingly, the preferred set of legal rules should be as follows. In principle, mergers between international firms should not come under the Merger Regulation. However, the Authority should be empowered to list those international firms that should notify the Authority and be subject to clearance if they merge. This method will enable the Authority to identify ex ante those cases in which it can apply a practical remedy to limit possible significant anti-competitive effects and to limit the uncertainty for foreign firms.

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[112] It is important to emphasize that while international firms are quite likely for reputational reasons to comply with legal requirement imposed in a merger decision, even one imposed by a micro economy, this does not imply that they will necessarily then choose to remain in the micro economy or even to enter it in the first place given such requirements. For the first proposition see, e.g., Katri Paas, *Implications of the Smallness of an Economy for Merger Remedies*, XV JURIDICA INT'L L. REV. 94 (2009).

[113] GAL, SMALL ECONOMIES, *Supra* note 4, at Chapter 6.

[114] Gal, *Unique challenges*, supra note 26.

[115] To give an example, when Unilever acquired control over Ben & Jerry’s and the merger raised concerns regarding competition in the Israeli ice cream market, the Israeli Competition Authority conditioned its approval on the distribution of Ben & Jerry’s ice cream in Israel through an independent distributor who will be free to determine prices charged for the products. The Authority also required that the quality or quantity of the products be at least as high as those in the pre-merger situation, and that any new product would be made available to the distributor. These are limited remedies since they cannot totally erase the fact that both firms are controlled by the same entity that determines their strategic decisions. At the same time, the small economy can often rely on the fact that the international firm will not change its strategic decisions (such as Ben & Jerry’s introduction of a new product into world markets) only to reduce competition in the small economy. In fact, it "free rides" on competition in larger economies.

Alternatively, a micro-economy's Merger Regulation should be broad enough to include extra-territorial mergers that affect its markets. The Authority should be empowered to impose structural or conduct remedies upon the merger, and accept undertakings and commitments from the merging parties, if the merger has significant adverse effects on its markets. Yet, in order to limit regulation that leads nowhere, foreign firms operating in a micro-economy should not be required to notify their merger decisions and be subject to clearance. Rather, the burden of spotting those extremely rare international mergers that significantly affect a micro-economy and for which practical remedies exist would be placed upon the Authority. Indeed, such a potentially post-merger remedy creates uncertainty for the merging firms, but this concern is minimal, as the effect of such a remedy will probably be insignificant for the international firms. It can also be addressed by enabling the firms to request the Authority to provide a pre-merger decision.

These suggestions system create a double benefit: on the one hand they reduce the burden on the Authority and on the merging parties in cases in which there is very limited chance that the merger will be prohibited, for normative or practical reasons. On the other hand, they still leave the door open for the Authority to impose a remedy in those rare cases in which the merger significantly lessens competition in a micro-economy and there is a practical solution to remedy some or all such effects. To create certainty, the Authority should be empowered to impose conduct requirements only within a pre-specified period of the date the merger was publicly announced. Note, that if it is assumed that the merger cannot be stopped, then the urgency in a decision is significantly limited, since applying remedies that deal with local issues can be done at a later stage.

One of the practical effects of this recommendation is the creation of a **"corridor" for regulation**: mergers should only be regulated if they are above a minimum threshold based on domestic turnovers and generally below a maximum threshold based on world-wide turnovers.

Unfortunately, this is not the case in some micro economies. Going through the list of merger decisions in Jersey, for example, reveals that most mergers examined are international and unsurprisingly none were prohibited. The same is true of other micro-economies.[116]

D. The balancing test

A micro-economy cannot simply evaluate the anti-competitive effects of a proposed merger. Rather, it is essential that the regulatory body be empowered to balance the anti-competitive effects of the merger with any pro-competitive or wider public policy effects that may result from it. Such a policy recognizes that a merger should be permitted if the improvements in efficiency or on other public policy grounds resulting from a merger are greater than and offset its anti-competitive effects.

A balancing provision is included in many Merger Regulations. Yet such tools vary with regard to the standard to be applied, the party which carries the burden of proof, and the institution which is empowered to perform the balance. Many jurisdictions adopt a limited balancing test. For example, Jersey's merger guidelines provide that "the focus is on whether

[116] See, e.g., Seychelles Fair Competition Act, *supra* note 108, at Section 22.

the efficiencies will enhance rivalry between the remaining businesses in the market."[117] This focus is ill-suited for a micro-economy. It is too narrow- it will only let through those mergers in which the merger will allow less efficient firms to increase their efficiency and as a result will increase competition. While such mergers should, indeed, be approved, so should mergers which increase efficiency substantially although they also substantially reduce competition. Indeed, most if not all mergers in a micro economy that allow the parties to realize scale economies would generally not increase rivalry. A better test for micro-economies is the one applied in the Seychelles, which allows the merger if it is "likely to bring about gains in real as distinct from pecuniary efficiencies that are greater than or more than offset the effects from limitations on competition..." Yet in order to reduce error costs, clear guidelines on the balancing exercise should be created and published.

D. Conditional remedies

The object of conditional remedies is to prevent some or all of the competitive harm that the merger would otherwise cause. There are instances in which only an outright prohibition can address the competitive concerns. However, in some instances other solutions can be found, and conditions imposed, to remedy most if not all of the anti-competitive harms. Such remedies can take two basic forms: (a) a structural remedy, which involves a change in the market structure (such as a commitment to divest assets), and (b) a behavioral remedy, which involves constraints on the conduct of the merged entity

The power to impose such remedies may serve as an important tool for a micro-economy, which should be more willing to apply them.[118] This is because such remedies enable the merger to go through while ensuring that it does not create harmful externalities, or at least that such externalities have been minimized. Thus, a merger that allows its parties to increase productive and dynamic efficiencies might be approved even if it significantly increases the market power of the firm, so long as the concession of the parties ensure that welfare is not significantly harmed.[119]

Structural remedies are easier to administer than behavioral remedies because they do not require medium or long-term monitoring to ensure compliance. The case of the *Ferryspeed/CHannelExpress*, noted above, serves as an example.[120] There the parties sold a warehouse that belonged to one of the merging parties to a third party freight operator in order to solve a bottleneck problem.

However, merger remedies in a micro economy may often be behavioral rather than structural. This is because a more concentrated market structure is often justified by productive efficiency requirements. Behavioral remedies do not prevent more efficient market structures from being erected, but limit their harmful consequences. The Jersey merger of *SPAR/several stores of Newsagents* serves as an example.[121] The proposed merger involved the acquisition of 13 stores owned by one distribution chain by another distribution chain. The

[117]Competition (Jersey) Law 2005 Guidelines- Mergers and Acquisitions, p. 12, www.jcra.je/pdf/050810%20Competition%20guideline.%20Mergers%20and%20Acquisitions.pdf (last visited Oct. 23, 2012).
[118] For a similar conclusion in the context of small economies see Paas, *supra* note 112.
[119] *Id*, writing about small economies.
[120] JCRA, Decision M005/05, *supra* note 92.
[121] JCRA Decision M114/07 proposed acquisition by SPAR (C.I.) Ltd. Of several stores from C.I. Newsagents Ltd. Similar decisions were taken in other economies.

JCRA concluded that the merger, as proposed, will have significant anti-competitive effects on competition in the market of retail services. These result from concentration of retail outlets in one part of the island and from a potentially wide non-compete clause. The JCRA thus conditioned its approval of the merger on the following conditions. First, the merged firm would commit to its current island-wide pricing policy for three years. This condition ensured that the merged entity would not take advantage of its market power in some parts on the island where limited competition exists. Second, the parties limited their non-compete clause to the duration of one year. This commitment ensured that potential competition was not restrained by the merger agreement. One of the downsides of behavioral remedies is the need to monitor them. As some cases around the world indicate, firms do not always comply with such commitments.[122]

Limiting price increases that result from a merger might also be considered. Although competition agencies are justifiably reluctant to regulate prices directly.[123] In mergers that increase market power there is a relatively easy benchmark: the pre-merger market price. Yet such a remedy is far from perfect. To name a few limitations, it requires on-going monitoring of prices, as well as other elements of the sale, such as quality and service levels; it requires the assessment of changes in market conditions on prices (e.g. increase in input prices) on an on-going basis; and the pre-merger price might not be the relevant benchmark in a changing world.

IV. Conclusion

Small and micro economies create policy dilemmas with regard to merger regulation. On the one hand, merger regulation can prevent anti-competitive mergers that create long-term effects on the economy that the market's invisible hand cannot correct. Yet the price of erroneous decisions that prevent pro-competitive mergers is high, as are the administrative burdens such a regulatory imposes. Accordingly, adopting a merger regulation, especially in micro-economies, is not trivial and requires a careful balancing of potential costs and benefits of the Regulation. This paper attempted to shed light on some of the considerations that should be taken into account when addressing this policy dilemma, as well as suggest tools for solving it.

[122] See, e.g., the Austrian case of *Wrigley/Joyco*, as reported in the OECD, *Annual Report on Competition Law Developments in Austria*, 14 (2003-2004).

[123] See, e.g., *Pros and Cons of Excessive Pricing Regulation*, Swedish Competition Authority (2007), http://www.konkurrensverket.se/upload/Filer/Trycksaker/Rapporter/Pros&Cons/rap_pros_and_cons_high_prices.pdf (last visited Oct. 23, 2012); Michal S. Gal, *Exploitative abuses in* EU COMPETITION LAW, chapter 9 (Ioannis Lianos & Damien Geradin eds, 2013).

Table A: Micro Economies (including miniscule ones)

Jurisdiction	Population	GDP (US$)*[124] (2011 unless otherwise indicated)	Island	Competition Law	Merger Law	Part of Regional Agreement with merger law
American Samoa	54,947	$575.3 million (2007)	yes	no	no	no
Antigua and Barbuda	89,018	$1.595 billion	yes	no	no	in the process of developing a merger law
Anguilla	15,423	$175.4 million (2009)	yes	no	no	in the process of developing a merger law
Aruba	107,635	$2.258 billion (2005)	yes	no	no	no
British Virgin Islands	31,148	$853.4 million (2004)	yes	no	no	in the process of developing a merger law
Cook Island	10,777	$183.2 million (2005)	yes	no	no	no
Curacao	145,834 (2010 est.)	$2.838 billion (2008)	yes	no	no	no
Faroe Island	49,483	$1.471 billion (2010)	yes	yes	yes	no
Dominica	73,126	$989.5 million	yes	no	no	in the process of developing a merger law
Guam	159,914	$2.5 billion (2005)	yes	yes	no	yes
Grenada	109,011	$1.468 billion	yes	no	no	in the process of developing a merger law
Greenland	57,695	$2.133 billion	yes	yes	no	yes
Guernsey	65,345	$2.742 billion (2005)	yes	yes	yes	no
Jersey	94,949	$5.1 billion (2005)	yes	yes	yes	no
Kiribati	101,998	$606.7 million	yes	no	no	no
Marshall Islands	68,480	$133.5 million (2008)	yes	no	no	no
Micronesia	106,487	$238.1 million (2008)	yes	yes	no	no
Montserrat	5, 164	$46.78 million (2006)	yes	no	no	in the process of developing a merger law
Nauru	9,378	$60 million (2005)	yes	no	no	no

[124] Population and GDP estimates based on the CIA World Factbook. Estimates relate to 2012 unless otherwise indicated.

Niue	1,269	$10.01 million (2003)	yes	no	no	no
Northern Mariana	51,395	$900 million (2000)	yes	yes[125]	no	yes
Palau	21,032	$164 million (2008)	yes	yes[126]	no	no
Samoa	194,320	$1.104 billion	yes	yes	no	no
Sao Tome and Principe	183,176	$383.9 million	yes	no	no	no
Seychelles	90,024	$2.274 billion	yes	yes	yes	no
St. Kitts and Nevis	50,726	$886.2 million	yes	no	no	in the process of developing a merger law
St. Lucia	162,178	$2.128 billion	yes	no	no	in the process of developing a merger law
St. Vincent and the Grenadines	103,537	$1.275 billion	yes	no	no	in the process of developing a merger law
Tonga	106,146	$772.8 million	yes	yes	no	no
Tuvalu	10,619	$37.47 million	yes	no	no	no
US Virgin Islands	105,275	$1.577 billion (2004)	yes	yes	no	yes

Micro economies that are economically immersed into larger ones

Andorra	85,082	$3.169 billion	no	no	no	no
Liechtenstein	36,713	$5.003 billion (2009)	no	yes	no	yes
San Marino	32,140	$1.136 billion	no	no	no	no

[125] The commonwealth's consumer protection law prohibits certain forms of price fixing, price discrimination, and exploitative pricing.

[126] Prohibitions are part of general business regulation law, http://www.doingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Law-Library/Palau-Law-on-Business-and-Business-Regulation.pdf (last visited Oct. 23, 2012).