Intelligence MEMOS

From: Larry Schwartz

To: Canada's Competition Law Community

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Re: THE EVOLUTION OF THE EFFICIENCY DEFENCE IN CANADA

Successive Commissioners of Competition have called for significant changes or outright elimination of the "efficiency defence" in the *Competition Act*.

No other G-7 country has followed Canada's approach to efficiency in merger review, noted the current Commissioner recently. He is right and it is worth asking: why?

The Act generally condemns mergers found to substantially lessen or prevent competition.

Section 96(1) is an important exception: an anti-competitive merger can be permitted if it brings about efficiency gains that exceed and offset the effects of any prevention or lessening of competition that will result from the merger.

In its first decision in the *Propane* case, the Competition Tribunal held that the existence of this exception, which is a defence in law, establishes that efficiency is the paramount goal of the merger provisions of the Act.

In 1966, the government mandated the independent Economic Council of Canada to study competition policy and provide recommendations.

The Council's 1969 report studied the structure of Canadian manufacturing industries and found that firms generally lacked the scale and specialization to produce at the efficient, minimum-cost levels. It identified the small size of the domestic market – then only 21 million people – as a key factor leading to a weak industrial base consisting of too many small firms producing too many products.

The Council also noted that a merger was a criminal offence that inhibited the required modernization of Canadian industry, considering the more liberal global trading environment that it correctly foresaw. It concluded that competition policy was a means to bring about more efficient performance by the economy as a whole. It proposed "the adoption of a single objective for competition policy: the improvement of economic efficiency and the avoidance of economic waste, with a view to enhancing the well-being of Canadians."

While acknowledging the redistributive effects of an anti-competitive practices and mergers, it advised that other policy instruments such as taxes and social programs were more effective ways to deal with distributional concerns.

To illustrate the static efficiency gain, if a merger of two competitors could produce the same total output as the two firms separately but at a lower total cost, the merger would increase economic efficiency and contribute to growth in productivity and living standards.

The Council noted that such efficiency-enhancing mergers could also create market power and lead to higher prices that would distort consumer and producer decisions, thereby reducing economic output and efficiency. Economists refer to this foregone output as the "economic cost" or "deadweight loss" of any merger.

The Council was also concerned with the potential for economic gains from "dynamic competition" arising from invention and innovation even if, citing Schumpeter, obtaining these gains might require a departure from the textbook notion of competition.

The Council recommended that merger policy should be implemented on a case-by-case basis. It advocated the creation of an independent tribunal that would "be primarily concerned with whether the merger was likely to lessen competition to the detriment of final consumers, and whether there were likely to be any offsetting public benefits."

The Economic Council's recommendations for a new competition policy were largely adopted in Bill C-256 (1971), although notably the proposed statutory efficiency defence required "passing on" of the benefits to the public. Furious opposition from the business community, largely because of separate provisions about registration of foreign investors, doomed the bill.

Five years later, an independent report accepted the Council's "single goal" of competition policy as economic efficiency. Regarding merger review, the report endorsed the suggestion that if the economic advantages of a challenged merger "effectively offset" the disadvantages due to market power, the merger would be approved.

But it took another 10 years, until 1986, for the creation of the *Competition Act* which contained the new civil-law regime for mergers. This approach, which focuses on allocative and productive efficiency, is the essence of the efficiency defence in section 96 that does not contain a "passing on" requirement.

The Competition Tribunal's first decision in the *Propane* merger case, which ignored distributional issues, was appealed. The Federal Court of Appeal endorsed the Tribunal's finding that s.96 makes economic efficiency the paramount goal in merger review. Nevertheless, citing US antitrust law, it instructed the Tribunal to take distributional issues and the objectives of competition policy listed in s.1.1 of the *Competition Act* into account.

The Tribunal's subsequent decision called attention to the history of Canadian competition policy, the Economic Council 1969 Report, the statutory history, and certain inconsistencies of US merger review, all of which the Court had not considered.

In its decision on further appeal, the Federal Court of Appeal held that the Tribunal had followed instruction and it raised no objection to the Tribunal's lengthy discussion of competition policy history and law.

If the focus of the efficiency defence in s.96 is to change, it should be based on independent evidence that it is no longer required in its current form.

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