Regulation: An Imperfect Substitute for Imperfect Competition

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Let me begin with three preliminary items.

First, I understand that it is the custom here, followed often but not always, to declare any interests. For purposes of appraising this paper you should know that I consult with News International and a firm in the renewable energy business, and have in the past consulted with many of the electric, gas and telecom companies in the United States.

Second, I ask your forgiveness if I paint with too broad a brush. Time, intellectual constraints, and the need to keep you awake combine to make that necessary.

Third, I would like to clarify one of the terms I will be using. As I use it, "regulation" means government action to replace competition that is ineffective because of the presence of natural monopoly elements, or has been seriously attenuated by government actions. I do not view efforts to maintain or restore competition by prosecuting cartel behaviour, artificially erected barriers to entry, or the unlawful exercise of monopoly power -- what you in the UK call competition policy, and we in the US call antitrust policy -- as a form of regulation. Indeed, to the extent that competition policy is effective, regulation is unnecessary. Put another way, it is the job of competition policy to make it unnecessary for the long arm of government to replace

Adam Smith's invisible hand. Because it is important to distinguish between the economic consequences of competition and of regulation, I will argue that when competition authorities decide to solve a problem presented to them by creating a regulatory mechanism, they have failed in their job.

In the hope that the phrase hasn't become a source of ridicule, I would like to go "back to basics". The basic theory of a market economy is that "the critical economic decisions are made by individuals, each separately pursuing his own interest, can nonetheless orderly and efficiently do society's work"[1] of ensuring that its resources are allocated to their highest and best use.

Two areas of the economy don't fit this model.

The first is the public sector, to which and within which resources are allocated by politicians, rather than by markets. Whereas markets allocate resources in response to effective demand created by consumers, politicians allocate resources to and within the public sector in response to the "effective demand" of voters as they perceive that demand, or wish it to be.

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[1] Kahn p.1.

The second area of economic activity that is not subjected to market forces is what we have come to call the public utility sector. This sector includes industries thought to have such extensive economies of scale that only a single seller can efficiently serve the market, and other industries thought to be of such crucial importance to the macroeconomy, and subject to market failure so pervasive as to warrant direct government intervention in the setting of prices and terms of service.

The public sector: It is an enormous temptation to comment on the consequences of the substitution of political for market resource allocation, especially since the public sector is consuming a larger and larger portion of the nation's limited resources. But I will avoid that temptation for two reasons:

1. It is, alas, beyond the scope of the paper I have been asked to deliver; and

2. Anyone who makes his or her office at any place other than Horseguards Road[2] doesn't need me to point out that central direction of the use of the resources that are being lavished on the public sector has resulted in an

[2] For American readers: the home of Her Majesty's Treasury, the driving force behind the rise in taxation and spending on the National Health Service.

inadequate return on that investment. Consider, as only two examples, reports in today's press that "almost half the operating hours in England's 300 day surgery units are not being used because of poor administration," and that "the gap between sick days taken by public sector workers and those in the private sector is the widest for four years," a phenomenon allegedly due to "stress."[3]

So I will confine myself to a discussion of the roles of competition policy and regulation, as those play out in the private-sector world.

The private sector and competition: The case for competition is clear, and three-pronged: it produces prices that reflect efficiently incurred costs; it accelerates innovation; it produces social mobility. Let me comment on each of those three virtues.

First, where competition is effective -- not perfect, but effective -- suppliers of goods and services have to vie with one another to offer the price-quality combination that most appeals to consumers. As Alfred Marshall long ago stated, in the days when the economic literature consisted of clear, equation-free prose, "If the producers of a commodity are many in number and act without any concert, it is to the

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[3] Financial Times, July 11, 2005.

interest of each of them to increase his supply of it whenever he expects to obtain a price greater than its Expenses of production. So that the price of a commodity cannot long exceed its Expenses of production, if there is free competition among its producers."[4] Which explains why it was such a policy advance to increase the deterrence to price-fixing by criminalising cartel behaviour.

Second, producers that cannot match the offerings of their competitors depart the scene, resulting in a continuing pressure on suppliers to increase productivity lest their costs rise to levels that make them unable to compete. In short, competition deprives producers of what Hicks described as the greatest monopoly profit -- a quiet life[5] -- by subjecting them to Schumpeter's gale of creative destruction.

I should add that the economic literature on this point is ambiguous,[6] since it recognizes the possibility that competition in product markets might deny innovators the ability to appropriate to themselves the fruits of their inventions, thereby discouraging expenditure on research

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[4] Alfred and Mary Paley Marshall, The Economics of Industry. Bristol: Thoemmes Press, 1994, reprinting the original 1879 edition, p. 180.

[5] J. R. Hicks, Value and Capital. Oxford: Clarendon Press, 1939.

[6] Here I draw on a paper presented a few years ago at a seminar sponsored by The Smith Institute and reproduced in my Lectures on Regulatory and Competition Policy, published by the Institute of Economic Affairs in 2001.

and development.[7] But here I rely on two experts, and some commonsense observations.

William Baumol, one of the closest students of the role of innovation, has concluded, “ [T]he unprecedented and unparalleled growth performance of the capitalist economies … [is due] primarily to competitive pressures, not present in other types of economy, that force firms in the relevant sectors of the economy to unrelenting in investment in innovation and that … provides incentives for the rapid dissemination and exchange of improved technology throughout the economy…. It can be argued that virtually all of the economic growth that has occurred since the eighteenth century is ultimately attributable to innovation.”[8]

Then we have John Vickers' formulation, offered in a paper considering the relation between competition and productive efficiency, "Competition seems very well in practice, but it is not so clear how it works in theory."[9]

Finally, we have a commonsense appraisal of real-life experience -- Microsoft's efforts to deny innovators access to

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[7] In this connection see Donald Hay and John Vickers (eds.), The Economics of Market Dominance. Oxford: Basil Blackwell, 1986, pp. 8-9.

[8] William J. Baumol, The Free-market Innovation Machine: Analyzing the Growth Miracle of Capitalism. Princeton and Oxford: Princeton University Press, 2002, pp. 3 and 13.

[9] John Vickers, "Concepts of Competition," Oxford Economic Papers 47 (1995), p.1.

markets and the effect that had on potential competitors' access to venture capital and ability to innovate; the rapid introduction of new electric generating technologies when competition was opened up in the electricity market; the innovative services offered by the airline industry when competition replaced regulation; and the comparison of efficiency in countries with and without competitive product and input market systems -- all of these examples suggest to me that competition means a fiercer gale of creative destruction than does the cozier world of cartels and monopoly.

These before-and after, and international comparisons, I hasten to add, are often problematic, and frequently involve large dollops of judgment, since the world is too unwieldy to keep “other things equal”, and too insensitive to the needs of economists to keep changes to those that practitioners of the art of regression analysis can both discern and quantify.

Third on the list of the virtues of competition -- competition has the advantage of providing the degree of social mobility necessary to maintain a consensus in favour of market capitalism. Good competition policy has as one of its goals -- and perhaps its main goal -- the preservation of freedom of entry. In product markets, that means making sure that there are no artificial barriers to entry other than those essential to ensure a rapid rate of invention and innovation (patents, copyrights). In the market for companies, freedom of entry means making certain that corporate governance rules prohibit devices that unreasonably inhibit the activities of “predators”, “sharks”, and other “takeover artists” who so upset the established corpocracy,[10] and who can bid more for assets than can the current operators because the newcomers can more efficiently operate those assets.[11]

The private sector and regulation: The goal of regulation, broadly stated, is to replicate competition -- to set prices similar to those that would prevail were the market effectively competitive, and to see to it that incumbents do not prevent newcomers from entering their markets other

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[10] In the takeover wave of the 1980s, many acquirers were “bust-up” artists, who sold off parts of the firms they acquired, often to firms in the same line of business. Andrei Shleifer and Robert W. Vishny point out that such a pattern was made possible by what they describe as the Reagan administration’s “new … hands off” antitrust policy. “Takeovers in the 1960s and the 1980s: Evidence and Implications,” in Fundamental Issues In Strategy: A Research Agenda, Richard R. Rumelt, Dan E. Schendel, and David J. Teese, editors. Boston: Harvard Business School Press, 1994, p.407.

[11] “Because assets tend to move through a competitive market to those who value them most, and who are therefore willing to bid the most for these assets, a poorly managed company is more valuable to outside investors, who are convinced that they can improve its performance, than to existing owners.” Thomas Sowell, Basic Economics: A Citizen’s Guide to the Economy. New York: Basic Books, 2000, p. 105.

than by being more efficient. It is important that we keep in mind just how difficult these regulatory tasks are, lest we make unreasonable demands on the men and women charged with doing the job of regulating the several industries for which they have been assigned responsibility.

The price-setting chore sounds rather simple: prices are to emulate those in competitive markets by being set equal to marginal costs, and by being set so as to return to investors the cost of their capital, taking account of risk. The daunting nature of the measurement problems should be obvious, and can be attested to by anyone who has sought to measure marginal costs or the cost of capital in any regulated industry, much less how to allocate the burden of recovering for the regulated entity the gap between the total of marginal costs and total enterprise cost.

But there is worse. Because there is no competition, regulators have no way of knowing whether the costs -- assuming they can indeed measure them with acceptable accuracy --on which they are basing prices are those of an efficient producer, or are at a level set by the slovenly management that is often the natural result of a market position ensured against challenge by virtue of its monopoly franchise.

To escape that problem, a host of regulatory devices has been developed, ranging from regulatory lag, which gives producers an incentive to lower costs by allowing them to keep the “excess profits” thus created for some years; “yardstick competition”, which presents its own set of difficulties[12]; and on to the now-famous RPI-X, which theoretically avoids the pitfalls of cost-plus regulation, and I might add, creates a whole new industry of X-men -- consultants who purport to be able to predict the optimal rate of increase in future efficiency, necessary to put a number to “X”.

It should be clear that none of these devices, no matter how cleverly applied, can equal the efficiency with which prices allocate resources in a competitive market. But where competition is ineffective, either because of the inherent economics of an industry, or because of market failure, or because society has decided that “fairness” requires replacing market forces with politically determined solutions, regulation is necessary. The important policy question thus

[12] “The difficulty of extracting unambiguous information from inter-firm cost comparisons undercuts the presumed virtues of yardstick regulation….[But] with better data and econometric techniques, yardstick comparisons may yet prove useful.” William B. Shew, Yardstick Competition and the Regulation of Natural Monopoly. Washington, D.C.: The Hudson Institute, 1999, pp.32-33.

becomes, “How do we maximize the contribution and minimize the damage done to the efficiency of an economy by the need to substitute men for markets as key decision-makers?”

The first answer is to make certain that we do not unnecessarily extend the scope of regulation. We have learned in recent decades that many industries we thought were “natural monopolies” are not, electric generation being the most obvious example. We have learned, too, that market failure is rarely as prevalent as politicians claim, and that “government failure” is often the greater evil. Finally, we have learned that notions of equity are subject to change, whereas the laws and rules created in pursuit of “equity” tend to endure.

Three forces are at work that ignore this recent learning, and create constant pressure to replace competition with regulation: politicians, market incumbents, and regulators.

Politicians can extend their power by substituting their decisions for those of the market, so they hunt for reasons to regulate. Those reasons usually come down to one thing: they don’t like the way markets are allocating incomes and resources. So we often find legislators imposing new duties on reluctant regulators, some of whom know a poison'd chalice when they see one. I should add that the spectacular success, from the government's point of view, of the 3G auction, has alerted at least some politicians to the advantages of free, properly designed auctions: we can only hope that they will find this lesson in the virtues of markets one that they can extend to other situations.

Market incumbents also often prefer regulation to free markets, on the quite correct theory that they can cope with regulators more successfully than with market forces, especially since regulators often feel a special responsibility to prevent their charges from failing. So we are treated to the unedifying spectacle of Britain's magazine publishers pressuring the Office of Fair Trading to construct an elaborate scheme of regulation and subsidisation rather than follow the OFT's instruction to introduce competition into the distribution end of the industry, the acquiescence of the CBI and other representatives of big business in regulations with which their members can easily cope, but which create barriers to the entry of less well-heeled firms, and a plea by large energy users for the regulation of energy prices in order to preserve their profit margins.

Regulators, too, often find reasons to extend the scope of their activities -- to suffer from mission creep. Regulators often find the temptation to expand their reach, which also involves the deliciously aggrandizing expansion of their budgets and staffs, difficult to resist. So they will often resist any calls to put their regulations to a cost:benefits test, and profess outrage when asked to do so.

I hasten to add two points. First, some regulators do not succumb to this temptation, as I will point out in a moment. Second, some regulators extend their reach not out of a desire for self-aggrandisement, but out of a genuine belief that they can enhance efficiency by devising ever-more-sophisticated regulatory schemes, rather than taking the often painful and radical measures necessary to restore competition.

We have two important examples of regulators who pressed hard to expand reliance on market forces, rather than on their staffs. In America, Alfred Kahn used his chairmanship of the Civil Aeronautics Board to push total deregulation of the airline industry. And in Britain, Callum McCarthy tried to extend the reach of competitive forces in the energy industries.

But these are the exception rather than the rule. Consider, for example, the recent decision of Ofcom to allow BT to retain control of its monopoly local loop, hoping that BT's binding commitments to allow equal access to competitors has made a referral to the Competition Commission and a possible break-up unnecessary. BT's separate business unit, to be known as Access Services, will be monitored by an Equality of Access Board chaired by -- get this -- a BT non-executive director. The company's shareholders were so chagrined at BT's loss of monopoly power that they immediately bid the shares up by more than 4%![13]

What BT knows, and a jubilant Ofcom apparently does not, is that the multifaceted aspect of access is so complex that regulation of access to the monopoly facility of a vertically integrated company, in the hope of producing equality of access, is virtually impossible. But assume for a moment that the incumbent does indeed offer competitors what can reasonably be called "equal access" -- treatment identical with that it offers its own affiliates. That may not be enough to put the competitor on an equal footing. As Princeton Professor Robert Willig has pointed out, the

[13] Financial Times, June 24, 2005.

challenger often needs some adjustment in the incumbent's technology in order to compete effectively. But obtaining positive cooperation rather than an absence of discrimination is no easy task, as competitors in the telecoms industry in America have discovered, and as new entrants into power generation are finding here in the UK, where vertically integrated power suppliers are, to put it mildly, not rolling out the welcome mat on their transmission lines for those who would compete with them in the supposedly competitive generation end of the business.

In short, I am willing to bet that Ofcom will soon learn what other regulators have learned. Any independent competitor knows that he is at a serious competitive disadvantage if standing between him and his potential customers is an integrated competitor that will determine the terms on which the newcomer will have access to those customers. True, that vertically integrated competitor will be regulated. And the regulator will attempt to see to it that the new entrant is granted access on non-discriminatory terms. But the regulator will either fail, because the terms are too many and too complicated to be effectively reviewed by a regulator, or because the incumbent can raise entry costs by dragging out the proceedings, or because non-discrimination is just not enough to assure access to customers.[14]

The situation is similar in the financial services industry. Vertically integrated firms are supposed to observe "Chinese Walls" to separate their deal-making investment bankers from their customer-advising brokers. But ask any CEO whether his choice of an investment banker is affected by the broker-researchers' reports on his company's shares, and you will get an incredulous, "Why do you ask? Of course I am not about to ask someone to go to the capital markets on my behalf when one of his colleagues has just rubbished my stock."

Which brings me to the rule that should tell regulators when they are capable of doing their jobs, and when they are not, and must instead take the steps necessary to create competitive markets. Get the incentives right. The incentives of the vertically integrated firm with monopoly power at one horizontal level are definitely not to make entry of competitors into other levels of the industry easy; the incentives of a bonus-dependent stock broker are definitely

[14] For a fuller discussion, see my "Vertically Integrated Utilities: The Regulators' Poison'd Chalice," in Lectures on Regulatory and Competition Policy, pp.123-143.

not to make the lives of his investment-banker-partners more difficult by writing negative reports on their clients' shares.

In instances such as this there is no substitute for vertical disintegration -- the solution that Ofcom found too daring in the case of BT, and Ofgem and the FSA do not have on their agenda.

I mention all of this not to impugn either the integrity or the good intentions of regulators. As I have said many times, Britain has been extraordinarily fortunate in attracting very able men and women to these most difficult jobs, and most have performed with distinction, especially given the fact that in the early post-privatisation days they were writing on a blank slate, and dealing with incumbents more accustomed to bending ministers to their will than to obeying rules set by regulators.

But it seems to me not unjust to add that these regulators are not likely to be the leading advocates for competitive as opposed to regulatory solutions, when the two approaches compete for favour. In the wonderful musical "Chorus Line", one of the bedraggled, under-earning members of the chorus is asked why she continues in that profession. The response, if I recall correctly, was, "A dancer has to dance." So with regulators: they have to regulate.

That is what the legislature has asked them to do, that is what their staffs want them to do, that is what market incumbents want them to do.

As Thomas Sowell has put it:

> Regulatory agencies are often set up after some political crusaders have successfully launched investigations or publicity campaigns that convince the authorities to establish a permanent commission to oversee and control a monopoly or some group of firms few enough in number to be a threat to behave in collusion as if they were one monopoly. However, after a commission has been set up and its powers established, crusaders and the media tend to lose interest over the years and turn their attention to other things. Meanwhile, the firms being regulated continue to take a keen interest in the activities of the commission and to lobby the state or federal legislature for favorable regulations and favorable appointments of individuals to these commissions.
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> The net result of these asymmetrical outside interests on these agencies is that commissions set up to keep a given firm or industry within bounds, for the benefit of the consumer, often metamorphose into agencies seeking to protect the existing regulated firms from threats arising from new firms with new technology or new organizational methods.[15]

[15] Sowell, op.cit., pp.95-96.

This is less true now than in the bad old days when "regulatory capture" was the order of the day. But it remains the case that the very existence of a regulatory body gives politicians and incumbents a place to go to complain about the low standards of potential entrants -- their lack of adequate capital; their inability to bear the cost of a "proper", top-flight regulatory affairs department containing the obligatory army of lawyers, accountants, consultants and lobbyists; and the dire consequences of failure by an incumbent. It is no surprise that we often find a symbiotic relationship between the regulator and the head of the department he regulates -- more regulations mean more staff and bigger budgets both for the agency and the company: deregulation might have them reading the "positions available" section of The Guardian, in the case of the bureaucrat, and The Times and Sunday Times, in the case of the company lawyer.

All of which is why I would like to suggest that we cannot count on regulators to be the voice for competition, or on the companies they regulate. That role must be played by the competition authorities, aided and abetted by the academic community, and the occasional politician who is willing to antagonise some existing constituency on behalf of the competitive ideal.

I can only hope to open a discussion of how that might be achieved in Britain. In the United States, the Antitrust Division often intervenes before regulatory bodies to advocate a competitive solution to the problems under study. I understand that a less formal process exists here, with the competition authorities meeting with the sector regulators to discuss issues of common concern. Since the American system is under continuous attack here for being too “rules-based”, and too formal, I am hesitant to suggest that our system, or some variant of it, might be worth a bit of study here. But I will overcome that hesitation, at least to the extent of wondering aloud whether Ofcom benefited sufficiently from an advocate of competition whispering it its ear that it, too, is mortal, and therefore unable to overcome the perverse incentives of a vertically integrated supplier with control of its competitors’ access to customers. Or whether Ofgem might benefit from a voice suggesting that competition in the generation sector will not reach its potential so long as transmission is controlled by generators. Or whether the FSA might not find its consumer-protection responsibilities more easily discharged if it separated deal peddling from share peddling.

I don’t know enough about the statutory powers of the various regulators to do more than raise these sorts of issues. But I do know enough about markets and regulation to know three things:

1. The task of regulating vertically integrated companies with monopoly power at one level of an industry so as to create “equal access” is somewhere between extraordinarily difficult and impossible.

2. Natural monopolies -- and, yes, even network monopolies -- are rarer than we once thought, and are often, instead, monopolies maintained by unnatural means. And “market failure”, frequently attributed to the inability of consumers to make choices as wise as those of ministers, is often the last refuge of power-hungry politicians, who do not recognise the possibility of “government failure”.

3. Where regulation is necessary, it is important to get the incentives right.

Thanks for you attention.

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