

Government in Markets

Speech to the Regulatory Policy Institute, Oxford

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I am delighted to have this opportunity to speak at the Regulatory Policy Institute's Annual Conference. The twin conference themes of 'the role of competition as an objective and instrument of public policy' and 'the challenges of integrating competition with other policy objectives' are enormously timely. They encapsulate some of the most important issues about the role of markets currently facing policy makers across the world.

This conference is also timely for me in a more parochial sense as the OFT will tomorrow publish 'Government in Markets: a guide for policy makers'. This provides a framework for analysing government's interaction with markets, and a guide to policy markets who are faced with setting up, influencing or regulating markets. We hope it will also make an important contribution to the ongoing debate about the role of Government intervention in different types of markets.

Towards the end of last year, I talked about 'competition in troubled times' and the new challenges that the financial crisis and global downturn were placing on governments. I spoke about the importance of framework advocacy for what competitive markets can deliver, including flexibility and innovation in addition to better value for consumers and business, rather than on specific

market issues of design and implementation. The importance of this message has not diminished.

In this speech I will focus in a little more detail on the various ways government intervenes in markets. I will argue that government and markets are inextricably linked, and that it is misleading to caricature the debate as one between state interventions on the one hand and 'free markets' on the other. However, I will argue that government intervention can easily, albeit inadvertently, damage effective competition and market dynamics as such damage tends to only become obvious over time and can be extremely difficult to remove or reverse.

So let me address three questions. First, why should government care about markets? Second, how has government's role changed, and what challenges does this pose? And third, how can we ensure policy making effectively balances competition and other policy objectives?

Why should government care about markets?

At their most basic, markets are a mechanism for allocating resources. Competitive and, where necessary, well-regulated markets can maximise consumer welfare and the performance of the economy. By raising economic productivity growth, markets also deliver even greater dynamic benefits over time.

When markets work well, firms thrive by providing what consumers want better and more cost-effectively than their competitors. As such, effective competition provides significant benefits for consumers through greater choice, lower prices, and better quality goods and services. Competition also provides strong incentives for firms to be more efficient than their rivals, reduce their costs and innovate, thereby helping raise productivity growth across the economy. The strongest case for competition is simply that, on average, it tends to provide better outcomes than alternative models.

And of course the case for competition in markets must always be based on evidence, both in terms of economic facts but also in terms of the tangible ways in which customers, be they individuals, companies or other institutions,

have benefitted. Our 'Government in Markets' paper provides many examples of how consumers have benefited from increased competition in markets. One salient example relates to the cost of international telephone calls from the UK which, following deregulation, fell by 90 per cent between 1992 and 2002. Over the same time period, the increased liberalisation of the European aviation market increased flight frequency by 78 per cent and lowered the lowest non-sale fare by 66 per cent. There are many such excellent examples; it is easy to forget the long and hard-fought battles to open such markets to competition, and to take the benefits for granted.

Left to their own devices, however, markets will not necessarily deliver the best outcomes for consumers, companies or government. In order to address this, government sets legal and institutional frameworks for markets and companies to operate in. That is, it puts in place rules and regulations that determine appropriate conduct of firms and individuals, and the institutions necessary for enforcing them.

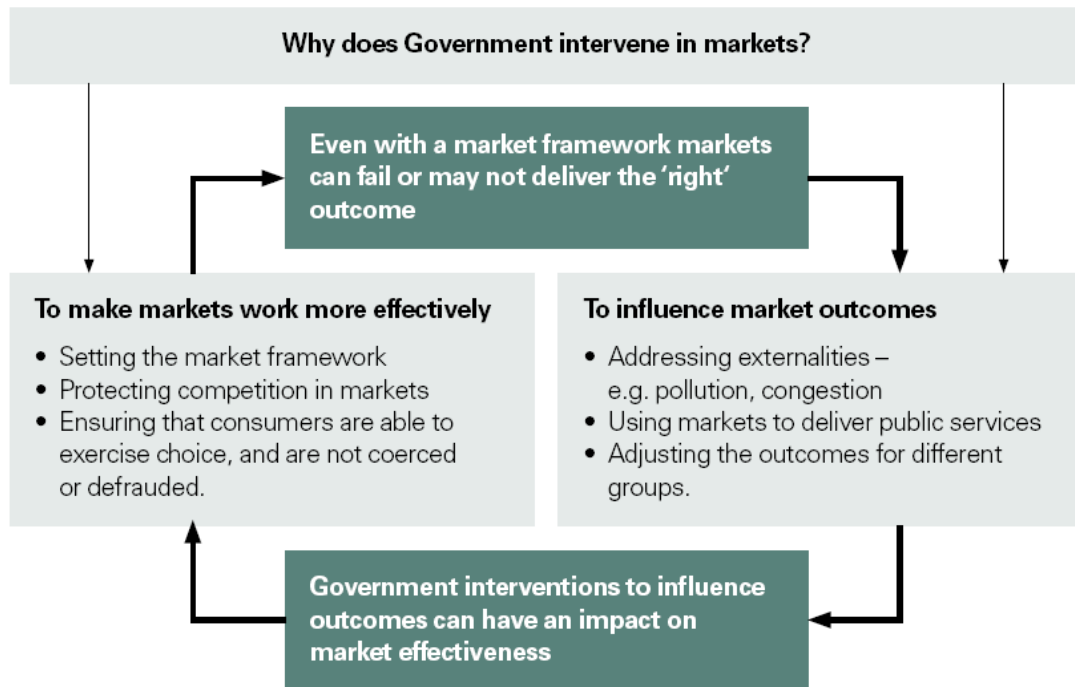
It is not always easy to make competition work well. Energy is one example of where increasing competition in a market has not been an unmitigated success. Whilst the liberalisation of the energy retail market in the late 1990s allowed customers to benefit from lower prices and an increased choice of tariffs, the energy regulator Ofgem has since had to deal with complaints about aggressive selling techniques and has had to develop solutions to help consumers compare the variety of offers. Similarly, we at OFT have found that the highly competitive airline sector throws up more than its fair share of consumer protection issues.

So - one risk is that the debate can easily, and incorrectly, be caricatured as one between state interventions on the one hand and 'free markets' on the other. In fact, government and markets are inextricably linked. Markets do not exist in a political vacuum, and neither should they. Government has a legitimate role in shaping the legal framework that markets and companies operate in, and intervening to make markets deliver broader policy objectives.

Why government intervenes

Government, in all its forms including regulators and competition authorities, has a legitimate and important role in both shaping markets and influencing market outcomes. (This distinction is set out in Figure 1.)

Figure 1: Government's role in setting frameworks and influencing outcomes



Government sets the framework that markets, companies and consumers have to operate in. Large-scale markets can only work effectively with certain prerequisites in place: the rule of law, effective enforcement of contracts and so on. Competition and consumer legislation also play an important role in setting the rules that govern the way firms and individuals should behave when operating in markets, and addressing the effects of market power.

Beyond this, there are many legitimate reasons why government might want to change the outcomes of markets. Some of these may be economic, relating to market failures.

There are three broad types of market failure, relating to market power, externalities and information problems. Competition policy, by prohibiting

cartels and the abuse of dominance, focuses on the first of these. Government intervention can similarly correct failures relating to externalities and the availability of information. For example, pollution has social and environmental costs in the form of climate change and health impacts, but without government intervention companies would have little incentive to curb pollution. Indeed, much consumer policy focuses on the consequences of information failure and, as our work on bank charges, airlines and other areas shows, market failures can be closely interrelated.

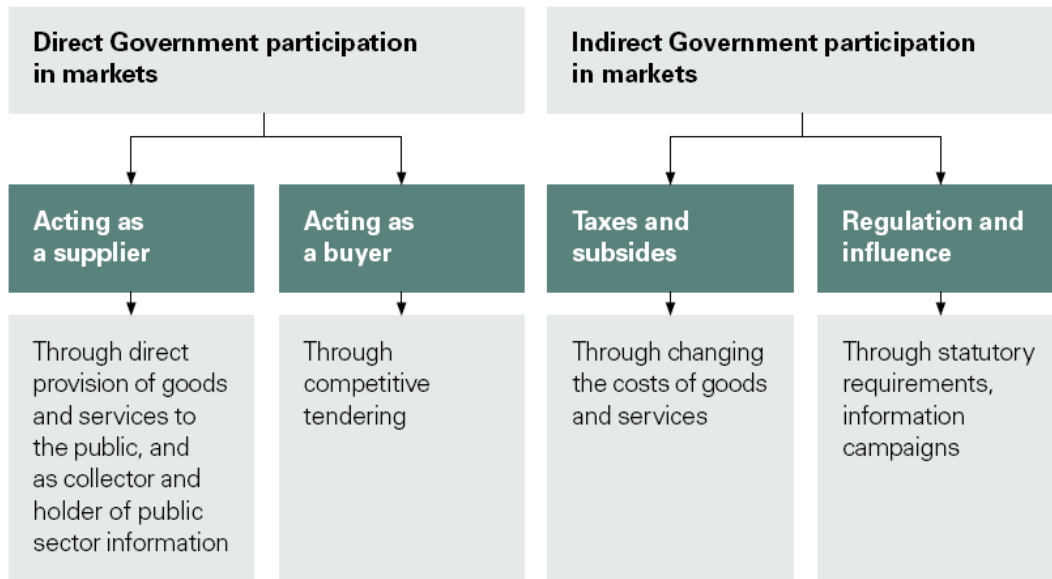
Although government can intervene to solve such problems, this may not always be necessary. The market frequently finds its own solutions. For example, market power can act as a spur to new, innovative entrants. Firms may be able to signal quality and overcome information asymmetries. Third party markets and players (for example, restaurant guides, reviews, etc) have long existed. More recently, the Internet has enhanced possibilities creating opportunities for beneficial innovation (not without new risks), and we would not wish intervention to stamp on this.

Government may also intervene in markets, not because of market failure, but to secure specific outcomes relating to other policy objectives such as distribution, regional policy, unemployment, and so forth.

How government intervenes

Government interventions can occur in a wide range of ways. These can depend on the role government plays within the market and on the outcome the government is trying to secure (see Figure 2).

Figure 2: How can government intervene in markets?



Government can participate in markets as a supplier or a buyer. It can also act indirectly as a regulator, and through taxes and subsidies. Increasingly Government is also exploring 'softer' ways of influencing the behaviour of firms and consumers. For example, recent Government policy statements on food have suggested that buy-one-get-one-free offers might encourage wastage. Generally, such initiatives have fallen short of imposing direct restrictions on business or consumer behaviour. This may, in part, be the consequence of the success of 'better regulation'. Policy makers, less desirous of using regulation to achieve an outcome (for example, salt in food, plastic bags), may see voluntary industry-wide arrangements as a substitute. While these may avoid some (but clearly not all) of the costs of regulation, they can have wider, and perhaps more subtle and serious, costs in terms of lost competition.

Our 'Government in Markets' paper looks in some detail about these various mechanisms and the ways that they can affect competition.

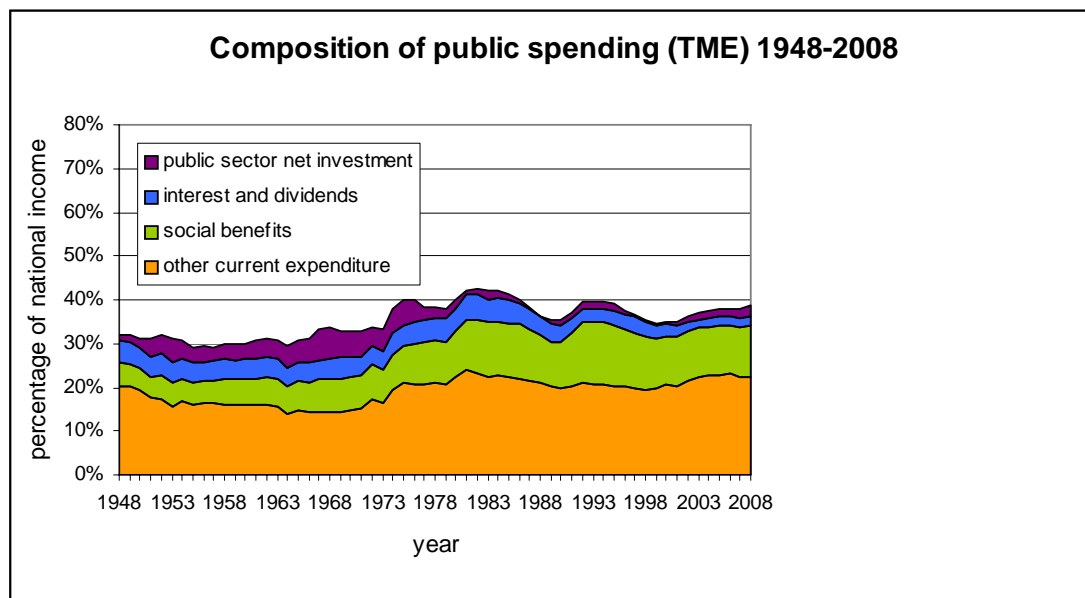
Government's changing role in markets

Understanding the breadth of government's role in markets helps to counter the notion that we have somehow been living in an age of unfettered free

markets. The most obvious long-term shift in microeconomic policy in the UK (at least since the Thatcher era and probably starting well before that) has been from direct government ownership to other more indirect forms of government intervention – notably regulation and procurement of goods and services. Arguably groups like the Regulatory Policy Institute are a product of this shift.

The idea of a dramatic reduction in the scope of the state conflicts somewhat with the evidence on public spending, although clearly public spending is far from an exact measure of the extent to which markets are used.

Figure 3: How Government's role has changed



An interesting question is how government will adjust to the lower rates of public spending growth anticipated by politicians of all colours for the foreseeable future. For example, will it make public service reform more or less likely? Will competition and choice be seen as drivers of efficiency? And what will it mean for government's use of 'softer' policy levers? Will there be a higher premium on trying to influence firms and consumers when it becomes harder to make the case for subsidies or regulation?

Aside from the economic downturn, there are growing global challenges which go to the heart of the relationship between government and markets. For

example, security of supply is increasingly being viewed as a political issue across several markets – energy and food among them. We hear warnings from some that markets will not be able to deliver, which results in calls for greater government intervention.

Does all of this mean that the benefits of competition will be overlooked? Not necessarily. But the burden of proof on the value of competitive markets may be shifting as we speak. In the recent past (in the UK at least) a preference for market-based solutions, based on confidence in the market process, may have meant that those arguing for intervention had the burden of showing its net benefits. In the future, it may be those seeking to maintain competition that bear that burden. Because we can never quantify and measure the full costs and benefits, and even a crude measurement is expensive, a small change in the burden of proof could have a big impact. If so, competition authorities, regulators and policy makers will increasingly have to make a strong case for what competitive markets can deliver. We shouldn't overplay the risks. But whether you take an optimistic or a pessimistic view, there are some basic arguments in support of competition and markets that we need to make. It is also why it is so important to point to past examples, and to engage in framework advocacy on behalf of the diffuse, dynamic and other subtle or less visible benefits of competition.

How do we maintain competition alongside other policy objectives?

Essentially, whatever the reason for government choosing to intervene in markets, how government chooses to do so is crucial both to the effectiveness of the intervention and to the knock-on effects on competitive markets. Importantly, if a government intervention undermines market dynamics, either intentionally or inadvertently, this can damage public confidence in markets more generally. What makes the policy making process so difficult in this regard is that damage to competitive markets is often initially hidden, only becoming obvious over time and can be extremely difficult to remove or reverse.

In order to avoid these unintended consequences, and at risk of generalisation, I'd like to pull out some important themes which cut across a number of the policy debates together with some indicative examples.

First, entry and exit of companies in a market is usually crucial to an effective competitive process, but often under-appreciated in the policy making process. Empirical studies of competition often show that a large proportion of the benefits can be traced back to entry and exit. For example, the evidence of competition in the airline sector suggests that many of the gains for consumers have come from the emergence of new entrants. Their new business models and approaches, alongside the responses they trigger from incumbent businesses, drive down prices and increase choice. Similarly, there are gains from the fact that, with liberalisation, the attention of senior management is focused on consumers and costs rather than on lobbying for protection.

However, whilst the policy making process will usually consider impact on, for example, small businesses, it is rare that such consideration is given to the impact on potential new entrants to a market. This is exacerbated by the fact that business groups, by their nature, represent incumbent businesses that don't want increased competition in their own markets, and thus find it difficult to represent 'enterprise' in its fullest sense.

Ensuring that entry and exit can work effectively is also a major challenge in making competition and choice work in the delivery of public services. For example, where there is excess demand for a service and real political constraints on exit (for example school or hospital closures) then simply enabling choice will not necessarily create genuine competition. A partial measure to improve competition could give the market a bad name and, in some circumstances, worsen the overall outcome. The OFT's own work with taxis is a case in point. We recommended that entry barriers, but not fare controls, be removed. Our subsequent evaluation showed benefits for consumers from lower waiting times, but lower productive efficiency due to underutilisation. Fares likely needed to fall, but could not.

A second cross cutting theme is that direct restrictions on competition are very rarely the best policy instrument for changing market outcomes. (By direct restrictions I mean both those regulatory measures which reduce competition by, for example, constraining prices, and other measures which allow firms to compete less vigorously.)

Think, for example, of fixing a minimum price for a product as a way of trying to curb consumption. This has a number of undesirable effects. It would reduce the incentives of firms to compete, innovate and cut costs. So the dynamic benefits of competition are lost. In some sense these costs are irreversible. Even though a minimum price or some other form of competition restriction might be removed in the future, this wouldn't immediately allow the market to discover the missed efficiency gains.

A minimum price would also create 'rents' or protected profits for industry. Although some of this may find its way back to consumers through reductions in prices on other products, full cost pass-through is unlikely. Once 'rents' have been established, industry will lobby to keep them in place. Furthermore, once 'rents' have been established in one sector, others may lobby government for similar treatment. This is one of the reasons why we have independent competition policy.

There is a political risk that in the interest of achieving a specific policy objective, weakening competition can be seen as an attractive short-term option where the alternatives might be to introduce a tax or implement more targeted regulation. It is the job of competition authorities to highlight to government where such a short term fix can have serious and long-lasting negative effects.

A third theme is for government to distinguish between consumer and producer interests, and to be aware of the biases that this entails. As a competition authority, we face a similar (albeit more limited) challenge of distinguishing between behaviour which affects competitors and behaviour which affects competition. Our clear remit is to protect the process of competition, not to protect competitors from the effects of competition. One of the main ways we achieve this is by focusing on the interests of consumers, who are the ultimate beneficiaries of competition.

The challenge comes particularly where changing markets pose threats to existing businesses and business models and government comes under pressure to protect them. Instead, the question for policy makers should be how to encourage innovative responses from both incumbent businesses and

new entrants. Consumers are invariably underrepresented in this process because they are diffuse, less personally affected, less informed, and less collectively organised than those on the producer side. The UK Government has implemented many policies to help address this bias (for example, Consumer Focus, supercomplaints, consultation processes, etc).

Related to this, and as I referred to before, there may be an evidential bias whereby the benefits of intervention to restrict competition may be easier to observe and quantify than the costs of lost competition. Related both because evidence comes from interest groups (so a bias in the latter will be reflected in the evidence base) and because of the diffuse and often hidden nature of the benefits of competition.

Where government unintentionally focuses on producer interests, it risks putting in place restrictions which preserve business models that are unsustainable in the long run while blocking innovative entry.

Role of competition authorities

Competition authorities and sector regulators have a key role in continuing to make these and similar points, and to help government think through the market impacts of proposed interventions.

For our part, the OFT was given a power in the Enterprise Act to advise government where its policies affect competition and consumer issues. Through the Impact Assessment process, policy makers must carry out a competition assessment for any proposed policy which is likely to have a material affect on a market. We regularly advise on these and engage with policy makers across government on the design of new policies. Recent examples have included environmental efficiency schemes and pensions reform.

More widely, the OFT carries out more detailed market studies. To date, around a third of these relate to public restrictions on competition. For example, past market studies have looked at the impact of regulatory restrictions in the pharmacies and taxi markets, and we have also looked more

directly at government's role in markets in our studies on, for example, subsidies, public procurement and the commercial use of public information.

And of course this is not just about the development of national policy. As Mario Monti set out in a recent article, competition bodies can play an important role in advocating competition in the wider international debate. The OFT has, for example, recently co-chaired a working group of the International Competition Network focusing specifically on advocacy. I share his view on the importance that the G20 should attach to supporting competition. A rise in protectionism at this time would do little to help economic recovery.

Conclusion

It is right that, at a time when various forms of protectionism pose an increasing threat to international competition, the UK takes a leading role in advocating open markets. Open markets are critical to the UK's long term economic success. The UK economy has eschewed the worst forms of protectionism and has consistently worked to break down trade barriers within the European Union. As a result, the UK and EU provide some of the best evidence of the positive economic impact of competitive markets.

Our role of international advocate for competition is most compelling when clearly demonstrated at home. A judicious and evidence-based approach to intervention will not only serve to benefit domestic consumers and taxpayers, but will also strengthen our ability to provide much needed international leadership on this issue, with long-term benefits for the UK and other economies.

In publishing 'Government in Markets', we want to contribute to a wider discussion on all of these issues. Although specifically designed to help policy makers identify and avoid unintended damage to competition, I hope it will encourage broader understanding of the vital relationships between government and markets.