Competition and Regulatory Policy and Economic Growth

Dermot Nolan
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Growth and microeconomics

- Economic growth often seen in macro terms
- For small open economy, much of our growth prospects determined by rate of growth in our trading partners
- But within that overall constraint, “micro” policies potentially important
- ESRI medium-term review mentioned possibility of delayed-adjustment scenario where, even if growth recovers in the Eurozone, possibility that Ireland could fail to grow if we pursue bad domestic policies
- Main focus on ESRI review was policy in the financial sector, but not unreasonable to think of it in terms of general microeconomic policies
Competition theory

- Within general ambit of microeconomic policy, competition policy and enforcement traditionally devoted to idea of promoting “perfect competition”
- Based on classic microeconomic idea of allocative efficiency – maximising sum of consumers and producers surplus
- Traditionally seen as a static concept – not obviously linked to economic growth
- Also seen as a “consumer” issue – related to ensuring consumers get fair value.
Doubts

- Competition policy sometimes seen – perhaps more in other jurisdictions - as inimical to industrial policy
- Idea of “national champions”, which may achieve economies of scale and scope allowing them to compete abroad is more obviously linked in policy makers minds to growth and job creation
- Push for jobs and growth rarely associated in policy makers minds with competition policy
- Some change in this last ten years, but still competition policy seen as rather ethereal
Competition and growth

- Considerable literature on competition leading to economic growth
- Perhaps that message has not been transmitted that effectively
- Idea is that increased competition enhances total factor productivity (TFP) – essentially (by allowing for better utilization of the various factors of production) shifting the production function outwards
- Also leads to innovation and creation of new products
3 mechanisms

- One is called the “within-firm” effect = exposure to competition makes firms more productive by removing X-inefficiency (Leibenstein, Harberger)
- “Across-firm” effect – productive firms increase market share and drive out unproductive firms
- Innovation and technology diffusion
Evidence

- Increases in competition lead to increases in industry productivity - for a survey see “Competition and Growth” Office of Fair Trading, 2011. Also see Holmes and Schmitz (2010)
- OECD work on this Scarpetta et al (2003)
Examples

- Air travel – removing barriers and facilitating competition. Huge expansion in scale and reductions in cost in European air travel over last 25 years
- Telecoms – fostering competition brought massive product innovation and new technologies over last 20 years. Many more people employed in many different firms producing more products at a much lower cost
- Key generally seen as removal of entry barriers
- Possible counter-example – banking?? Were Anglo or Northern Rock seen as innovative market entrants at the time?
- FCA in London now saying it will act early to limit financial innovation
Ireland

- Role for competition in Ireland predominantly seen in the non-traded sector where some evidence exists that costs are high
- Non-traded sector operating in smaller market, and possibly protected by entry barriers
- Competition policy in this context can be seen as complementary to competitiveness policy – providing a lower cost base for FDI
- Increased competition enforcement potentially reducing cost base and thus potentially enhancing locational attractiveness for FDI
Regulation

• Regulatory policy not the same as competition policy
• Some sectoral regulation is essentially attempting to mimic competition – natural monopolies will never be competitive. These are subject to price regulation.
• Some sectoral regulators also charged with moving former monopolies toward effective competition
• Trying to achieve competitive outcome, albeit imperfectly
“Non-competition” regulation

- But many other aspects of regulators (and the set of regulators goes far beyond what are seen as the sectoral regulators) involve setting rules and restrictions
- Almost by definition, these have the potential to limit entry and competition. This does not mean such rules are not necessary, but they may place restrictions on entities
- Most obvious examples are prudential rules and regulations on financial institutions
Regulation and information I

- Key commonality to many regulatory decisions is asymmetric information – regulated entity is better informed than the regulator.
- Crucial in any pricing decision – how do you measure efficient cost of a natural monopoly?
- Company knows its true cost but has an incentive to overstate it to regulator. If regulator sets cost too high then tolerates inefficiency; if costs too low company unable to operate. Many different measure of efficient cost.
Asymmetric information also vital in other aspects of regulation – notably prudential regulation.

Strategic goal of financial stability based on ensuring that financial institutions stable – how does regulator know they are?

Requires information about assets and liabilities that is inherently complex.

Financial regulators have increased staff to try and reduce information asymmetry.
Does regulation damage productivity?

- Regulations often resented by business as constituting “red tape” and raising costs - some evidence to support this
- UK Department of Business, Enterprise and Regulatory Reform (BERR) – “Impact of regulation on productivity” (2008) referred to several studies (Nicoletti & Scarpetta 2003), (Gelauff and Lejour 2008) which found that product market reforms that reduced administrative burdens had strongest effect on TFP
- But BERR report also cited many examples of “good” regulation which they called “win-win” in terms of protecting consumers and enhancing productivity
- Many of these benefits are in the area of diminishing uncertainty. But can be very hard to quantify costs and benefits in this regard
Example

- Vickers Commission report (2011) was one example of an attempt to quantify costs and benefits of increased regulation
- Recommended ring-fencing of wholesale and retail portions of banks
- Gave rough estimates of private costs of this to banks via operation/transactional costs and reduction in liability diversification
- But tried to estimate social benefit of ring-fencing in reducing future financial crises.
- Average financial crisis costs 60% of GDP; happened approximately every 20 years; implies would be willing to pay an insurance premium of 3% of GDP to avoid them
- Flaws in this, but interesting.
- Vickers argued that this measure would actually facilitate economic growth by minimising instability and uncertainty and creating a stable base for investment
- Also argued it would increase competition
Regulations in energy

- Ring-fencing in other sectors too – common in integrated energy businesses, such as ESB
- In energy, mainly designed to reduce cross-subsidisation and distort competition
- But energy regulation has rules/restrictions that have similar features to banking - as with the economy needing to have a banking sector, it needs secure energy supplies
- Rules around security of supply – require some form of “buffer” to peak electricity demand. Informed by estimates of value of lost load (VoLL) – loss of welfare suffered by not having electricity
- Inherent balancing of risk and benefits – essentially trying to minimise total costs while facing a constraint that lights stay on/banks continue operating
Regulatory stability

• One major perceived advantage of regulation is ensuring stability
• Vickers discusses positive effects of financial stability
• Energy having stable and reliable sources of supply; telecoms having sources of broadband
• Stability perceived as good for investment both within the regulated sector in providing clear signals for investors, and within the wider economy as giving a stable environment for investment
Political stability?

- Further perceived advantage of regulation is it is independent – that it is not subject to political “interference”
- Inherently controversial as it implies that some decisions will, over time, necessarily be poor decisions if made by elected politicians
- Most strongly in the case of central banks, where independence written into European Treaty itself
- But also energy, telecoms regulators required by EU to be independent of Government
- In energy, European Commission worried about Governments systematically subsidising the cost of energy, which sends “wrong” economic signals
- Also argument that investors will refuse to invest if, for instance, they invest hundreds of millions in a generation plant or networks business that the Government then immediately reduces in value by changing policy
- Many European governments still subsidising, arguing that inelastic demand means consumers hurt by rising prices, and businesses rendered uncompetitive
Clear efficiency gains

- But regulation can bring more tangible efficiency gains too
- Telecoms spectrum regulation – 4G auction immensely successful in terms of boosting tax revenue, but also the whole area of spectrum regulation key in terms of permitting harmonisation of spectrum and permitting innovation
- Energy regulation – costs of running the electricity network driven down by approximately 25% since 2000. Availability of ESB electricity generators has increased by approximately 10-12% since formation of Single Electricity Market in 2007
Policy and regulation

- Tensions remain….
- Policymakers suspicious of risk of regulatory capture, plus worries about stifling effect of regulatory rules.
- For example, issues of IFSC and whether regulation preventing investment. Some similar issues in energy.
- Regulators worry about random Government intervention, and about willingness to take on vested interests