

Competition and Regulatory Policy and Economic Growth

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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)
- Evidence from the UK: Geroski (1990), Nickell (1996), Crafts & Mills (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

Regulation and information II

- 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 reduced 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 off 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