

Productivity, Regulation, and Competition: Policies for Natural and Unnatural Monopolies

Lecture by Irwin Stelzer*, Sponsored by The Smith Institute
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It is a great pleasure once again to participate in the Smith Institute's series of seminars. These sessions are effective: they already have resulted in substantial improvements in competition and regulatory policy, and recently helped to push immigration policy in a sensible direction.

Let me begin with my usual declaration of interest, a practice I believe is followed some of the time by some members of Parliament. I am a consultant to News Corp and News International, and to a wind farm developer, and have in the past been a consultant to many US energy companies and to BSkyB

Fortunately, regulatory and competition policy in Britain has come a long way. The privatisation of a host of service providers – in the telephone, gas, electric, water, airline and other industries – has proved an enormous success, for

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reasons I have laid out in earlier talks here, and which I understand Professor Newberry will discuss in some detail. The regulatory regimes established for industries in which the invisible hand remains – or is believed to remain -- too atrophied to control business behaviour have been broadly successful, although some critics of the electricity regime argue that the current and impending shortage of electric generating capacity is due to shortsighted regulatory policies that refused to allow adequate recovery of investment.

Perhaps most important, we have learned that there are fewer markets in which economies of scale are so great that only a single supplier can serve them efficiently. We have found that it is indeed possible to have competition in some segments of the gas and electric industry, and in the telephone and related industries, and that once we factor in considerations of dynamic rather than static efficiency, natural monopolies are few and far between.

But there is a long road yet to travel. In the remaining so-called natural monopoly industries we have yet to develop a policy that satisfactorily responds to the monopolistic practices of major energy companies on the Continent – if indeed any response is required. Nor have we solved the knotty problem of regulating vertically integrated

firms possessed of monopoly power at one horizontal level of the industry in which they operate, but facing competition (actual and potential) at other strata of the industry.

Telephony presents but one example of such an industry. Ofcom believes it has solved this problem by setting up a regulatory system that requires BT to offer equal access to its monopoly facility. I do not believe that will work: as with electric power transmission, the terms of access to BT's monopoly wires are too multifaceted and complicated, and its incentives to adopt tactics that unreasonably disadvantage potential competitors in down-stream markets too great, for anything except divestiture to provide free and open competition. In my view, we have here a failure of the traditional regulatory regime to devise a solution to a knotty problem.

But I do not want to begin your day with a list of problems. Many industries have been freed from the dead hand of state control, thanks to Margaret Thatcher, and from the whimsical attitude towards needed investment that is the dominant mode of thinking among politicians, by moving them into the private sector. Britain now has a more vigorous competition policy, thanks largely to the Chancellor, who sponsored that policy in the face of

opposition from the business community and a lack of interest on the part of many of his colleagues. And the regulatory regime has been implemented by a host of extraordinarily able people.

The problems that policy makers now confront relate to firms and industries that are not “natural monopolies”, that is, they are not entities that serve markets in which costs will be lower if only a single supplier operates.¹

Consider, for example, the financial services industries. Here we have an industry with two characteristics that justify regulation. The first is that it is rife with structural conflicts of interest. One need not be a fan of the high-handed tactics of Eliot Spitzer, the New York State attorney general who has been the scourge of Wall Street, to appreciate that a firm that both advises the public on the quality of a company’s securities, and seeks investment- banking business from that same company might, just might, be inclined to prefer stock tipsters who are of a naturally optimistic disposition.

Second, the financial services industries present a classic case of “information asymmetry”: the sellers of services are far better informed than the buyers. I hesitate to

¹ See Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions*. Cambridge, Massachusetts and London, 1988, p.11. Reprinted from the two-volume edition first published by John Wiley & Sons in 1970-1971.

mention this in the presence of Ed Balls, who sees information asymmetry everywhere he looks, so that in his world to grant consumers choice – say, of health care providers, courses of treatment, or schools – is to doom the consumers to disappointment, a fate that can only be avoided if the consumers' decisions are made for them in Whitehall, or better still in this building!

So some form of regulation is necessary, although not the control of prices and profits that we generally associate with a regulatory regime. Here we need one of two things, or perhaps some of both. Most desirable would be structural separation of investment banking from other parts of the industry. Indeed, markets are already creating such non-conflict-ridden entities, witness the success of boutique investment advisory houses and of firms that do nothing other than give “fairness opinions”. So the questions are: (1) can we rely on markets to bring to an end the conflicts of interest inherent in the current structure of the financial services industry, or is more vigorous regulatory intervention is required; (2) what form of regulation is necessary to counter the information asymmetry characteristic of some financial markets, or can incentives be developed to align interests of consumers and service

providers; and (3) is there any hope that a long-run educational programme can reduce that asymmetry, as gradual education of consumers has done in health care markets?

Then there is regulation that is made necessary, not by natural monopoly elements or by information asymmetry, but by what I will call the unnatural monopoly power conferred by government, either by action or inaction, on providers of public services such as health care and broadcasting.²

Surely, there is no significant natural monopoly element present in the labour-intensive health-care industries; surely, there is no reason why large components cannot be subjected to competition – and I mean real competition, not the sort that imposes on private-sector firms the labour and other costs borne by the incumbent. Imagine: suppose that the US government told Toyota and Nissan that they are free to compete with General Motors and Ford, but they must pay their workers the same wages and benefits as the American companies. Consumers would not benefit from the improved quality and lower prices that real competition has brought.

Improving the appalling productivity performance of the health care sector is extraordinarily important because,

² Portions of the following section were included in a lecture sponsored by Politeia on March 7, 2006.

unfortunately in my view, the state is claiming for itself an increasing share of the income produced in Britain, up from a low of about 37% to the current level of about 42%. That means that an increasingly large portion of the economy and of the work force are shielded from competition, but are not susceptible to regulation as we have developed it in other industries with strong monopoly elements, or to competition policy. The effects on national productivity are predictable. The latest ONS figures, or at least those that are not laughable, show that productivity in the NHS is declining, pulling down the national average.³ This, despite massive and pervasive target-setting, a process that is the delight of public-sector gamesmen, and despite periodic reviews by bureaucrats far removed from the hospitals and schools for which they devise and revise performance targets. The moral: regulation of unnatural monopolies is no substitute for competition in meeting consumer needs efficiently.

Surely, and especially important if we are forced to accept the expansion of the state to a point where it is gobbling up over 42% of GDP (and rising), there is room to improve the efficiency with which that money is spent. After

³ The ONS has published a wide range of estimates, including seriously flawed productivity measures that show annual improvement of 1.6% between 1999 and 2004. The more plausible figures suggest the productivity is declining, perhaps by as much as 1.5% annually in that period. ONS, "Public Service Productivity – Health", February 2006. See also [The Economist](#), March 4, 2006.

all, objections to the massive rise in spending on the NHS would certainly be muted if that money had been and was being well spent. We know from experience – experience in the Kremlin and in Horse Guards Road – that centralised setting of targets produces gamesmanship rather than efficient behaviour.

That means that if we are to get value for the money spent by an increasingly large state, we must develop mechanisms that force public sector employees to do more than serve time until their generous pensions become available. Not all such workers: no disciple of Adam Smith would deny that we wish to appear admirable in our own eyes and in the eyes of others, and that therefore it is unsurprising that many public sector workers are dedicated, and probably expend huge amounts of energy circumventing rules that prevent them from doing a good job in the public interest.

Still, as the state expands, it becomes increasingly important to create incentives for efficient behaviour. The great economist and Nobel Prize winner R.H. Coase points us in the direction of a solution, which he acknowledges is merely an extension of Adam Smith's earlier argument. He writes, "Private individuals are constrained in their folly

because they personally suffer its consequences....

But...men who bankrupt a city or nation are not necessarily themselves made bankrupt.”⁴

The question, then, is how do we remove the insulation that protects public service workers from the consequences of such of their acts as result in the efficient use of the resources made available to them? The answer is to inject competition into the provision of such services, to – and I hesitate to use this much over-used word – “empower” the consumers of these services. We have seen from experience that the transformation of the providers of a wide range of services from nationalised monopolies into private sector competitors results in enormous efficiency gains. Given the blessing and power of choice, consumers forced their gas, electricity, telephone, airline and other companies to improve the quality, value and variety of services on offer.

Therein lies the guide to future policy vis-à-vis the public sector: introduce competition wherever feasible so that poor service will result in an atrophying of inefficient providers that prove unable or unwilling to improve their performance. Parents with education vouchers would be free to flee bad schools and provide funds for the expansion of

⁴ R.H. Coase, Essays on Economics and Economists, Chicago and London: The University of Chicago Press, 1994, p. 115.

good ones, and patients with freedom to choose their doctors and courses of treatment would put unhelpful health care institutions that refuse to upgrade out of business – the idea that “information asymmetry” makes this impossible is a nonsense (but that is a subject for a separate talk). Bad teachers, inattentive doctors and nurses, would be forced, if I might use a nautical phrase, “to shape up or ship out” in favour of educators and health care providers who best meet parents’ and pupils’ needs.

No doubt transition will involve pain, but that pain would be transient, and trivial compared to the pain being inflicted by the current system of provision. After the injection of huge sums into the public services it is no longer reasonable for opponents of submitting public service workers to the refreshing gale of creative destruction to argue that there is insufficient excess capacity to provide meaningful choice. Such capacity will develop further only when the demands of thousands of parents and patients can find expression. The response won’t be instantaneous, but it will be noticeable a lot sooner than most who oppose these reforms are willing to concede – which may explain the rabid hostility of some interested parties to such reforms.

Which brings me to still another regulatory issue: environmental regulation. If done badly, such regulation can be terribly expensive and reduce productivity in several industries. If ever there were a field in which command-and-control regulation – telling businesses and consumers what to do and how to do it – has been shown to be inferior to incentive-based regulation, this is it. Fortunately, the Government is beginning to understand that by internalising the cost of pollution in the cost of consumption – making prices reflect the costs that consumption imposes on society, using taxes to do so – we can do a lot more for the environment than by direct mandates – or even by putting wind machines on top of our houses.

But one must be careful when suggesting new taxes, especially in this building, since such a suggestion is likely to resonate with the current tenant. So let me add three thoughts. First, the tax must be no more than the best estimate of the cost imposed by the pollution, lest it distort resource allocation. Second, the tax must be sensibly crafted: to tax nuclear plants as if they emitted greenhouse gasses is not the most sensible policy – there are other reasons to tax nuclear, but carbon emissions should not be on the list. Third, in this already highly taxed nation, any

green tax should be offset by an equivalent reduction in taxes on investment and jobs.

The lesson here: having solved many of the problems associated with traditional natural monopolies, imperfectly to be sure, but reasonably well, in the case of environmental regulation we have to be as clever in designing new forms of regulation, aimed at new problems, as we were in designing regulatory regimes to cope with natural monopolies. Those forms must rely more on getting incentives right, and less on getting rules right.

Another question we might think about during this series of seminars is the problem created by BBC, a massive, state-funded entity that has sufficient political power to obtain an ever-increasing exaction from a diminishing customer base, and to have that rising share guaranteed for the foreseeable future.

It is, of course the case that BBC is an important and widely admired fixture in Britain's social life. As it should be. The question, however, is whether, in addition to its special funding treatment that removes it from the pressures the market exerts on ordinary firms to respond to consumer demand and to be efficient, it should be permitted to engage in the sort of conduct that would put ordinary firms in

violation of competition laws. For example, economists have long recognised that pre-announcement of new products or services by a dominant firm can be an anticompetitive tactic, designed to head off entrepreneurial competitors. Just as IBM at one time, and Microsoft more recently, can dry up the financing of a potential competitor by expressing an interest in the market the newcomer is prepared to enter, so can BBC. Or, more directly, it can put enormous pressure on a competitor that relies on subscriptions or advertising by simply offering a similar service at what appears to be no charge, as BBC has done to Sky with its News 24.

This is not the place to devise means of regulating an entity with such political power, an assured source of revenue regardless of its ability to offer a product consumers want and operating more or less free of the ordinary constraints that bind firms with a similar degree of market power. That is a task that we must leave for another seminar, although I hesitate to suggest such a session since the power of BBC generally trumps the power of intellectual argument.

Let me conclude with this cheerful note: we have solved many of the problems we once faced with natural monopolies, either by introducing competition when

technology and better economic analysis indicated, or by developing workable regulatory techniques. Our next chore is to develop competition policy to the point where it can more quickly cope with anticompetitive practices; to develop efficient and acceptable methods of regulating, restructuring, or exposing to competition industries in which monopoly power is “unnatural”; in which the government is the source of monopoly prices and inefficiencies; in which information asymmetry or structural conflicts of interest prevail to an extent that distorts competition; in which a pervasive state presence is an impediment to efficiency; and in which prices do not reflect the true social costs imposed by consumers when they fly, drive, heat, cool, eat, smoke or engage in other activities in which they impose costs on others.

That’s an agenda grand enough to warm the heart of Wilf Stevenson and his colleagues at the Smith Institute. The real challenge is to develop these techniques by relying to the greatest extent possible on markets and economic incentives, the other Smith’s invisible hand, rather than the long arm of regulators.

Thank you for your attention.

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