Productivity and Regulation:

Social or Economic Regulation?

Lecture Sponsored by The Smith Institute

Irwin Stelzer*

at No. 11 Downing Street, London

3 May 2005

There is an inherent contradiction as well as much good sense in our assignment today. But before commenting on both the contradiction and the good sense, let me point out that this seminar is only the latest in a series that has taken us from defending a vigourous competition policy, including the criminalisation of cartel behaviour; through a discussion of regulatory policy; and on to a demonstration that competition policy, properly implemented, can make an important contribution to

- Improved productivity
- More rapid innovation
- Social mobility, and
- Superior macroeconomic performance

In this journey we have been fortunate to have the support of the Chancellor, not only in providing the venue for these discussions, but in implementing the results of our

---

* Director of Economic Policy Studies, the Hudson Institute; columnist, The Sunday Times; contributing editor, The Weekly Standard; Honorary Senior Research Fellow, The Smith Institute.

deliberations. His decision to take our deliberations seriously has raised this series from a mere talking shop to a real-world policy player.

But enough of praise for Gordon Brown and his representative on earth, today's chairman. Let me begin with the usual declaration: I have several clients with interests in how competition and regulatory policies are formulated and implemented.

Now, to the good sense that shaped today's programme. We are instructed by Wilf Stevenson to ask ourselves whether it is good policy to impose on independent regulators the task of achieving non-economic policy goals. That such tasks are imposed on regulators is obvious from even a cursory glance at the state of play in regulation. Water regulators are asked to enforce environmental policy goals; energy regulators are faced with the chore of implementing often incoherent non-economic policy objectives; telecoms regulators face pressure to ensure universal access; financial regulators are supposed to figure out how to educate the public to make reasoned choices among the multiple products on offer, and to solve the pensions crisis; media regulators are asked to test the suitability for private viewing of the content of broadcasts, applying the superior morality of the public sector; and if BBC were subjected to meaningful regulation, which it is not, its independent overseers would be required to implement a variety of social objectives, including deciding which events are of such cosmic importance that only BBC can be trusted to make them available – to its dwindling audience.

This state of affairs, this use of regulation to achieve social goals, exists because when the so-called natural monopolies that provided many of these services were subjected to competition, their ability to cross-subsidise was diminished. I can remember when AT&T in its original, monopoly incarnation thought it desirable social policy to offer special low telephone rates to members of the clergy, subsidising those rates by imposing above-cost rates on captive residential consumers; and when distributors of electricity could offer derisorily low rates for street lighting, to appease cash-strapped local politicians, and recoup from customers who had no alternative to make up the revenue shortfall.

These monopolies were responding to their understanding of the social policies that their legislative and regulatory masters favoured. When the injection of competition ended their ability to recoup the losses resulting from subsidising favoured customers from other customers, they lost their ability to be instruments for the implementation of social policy.

To the consternation of politicians. After all, these utilities bore the cost of the policies that legislators loved, but for which they were reluctant to pay by overtly raising taxes. Instead, the cost was buried in utility bills. Or, in the case of some environmental regulations, in the cost of goods produced by the regulated companies.

Does this make economic sense? In those circumstances in which the user of the service imposes costs on society – externalities, in economists' jargon – it is efficient for legislators to mandate the outlays necessary to eliminate those externalities, and for regulators to reflect those costs in the prices regulated companies are permitted to charge. This transfers costs from society to the consumer of the good or service. Thus, when water companies are required to incur costs to fulfill the wildest dreams of purity afflicting the Brussels bureaucracy, it is incumbent on regulators to allow water companies to reflect those costs in the charges for consumption of water. Or, when legislators order the installation of scrubbers to reduce the pollution associated with coal-fired electricity generation, the cost of that equipment should properly be imposed on the consumer.

The harder case is when politicians – and unlike those in Brussels, politicians in Britain have to be accountable to voters – fear reprisals if they are identified with tax or cost increases imposed on consumers. Faced with voter unhappiness, they ask regulators to do their dirty work – in the case of pollution, their clean work – for them. At times this means setting standards of service to which regulators must hold those they regulate, cost be damned. At times politicians instruct the regulators to insulate some favoured consumer group from these charges – pensioners, low earners, favoured industries. In effect, they are asking the regulator to redistribute income, the equivalent of raising taxes on non-favoured consumer groups, by – if I may use the term in this house – stealth. That subverts the democratic process, and allows the politician to achieve a goal for which he dare not seek voter approval.

In considering this issue we should not reserve our scorn for politicians who seek to fly under the voters' radar when it comes to assigning responsibility for higher costs and prices. Many industries are equally guilty, conjuring up reasons why they deserve special relief from bearing the uninternalised costs their activities impose on society. But I leave it to Sir Digby to explain why I have missed some important point here!

Let me now turn to the inherent contradiction in today's charter. We are asked to consider whether the shift from promoting competition to an emphasis on social and political objectives is good policy. That formulation misses an essential point: the promotion of competition automatically, as if by an invisible hand, achieves many desirable social objectives. To shift from promoting competition more often than not is to de-emphasise, rather than emphasise, many social and political objectives.

Remember, when we talk about the role of regulation we are talking about policy towards dominant firms. We are not concerned with tiny enterprises that have no choice but to serve the demands of the market – they are price-takers, not price-makers. We are dealing with firms with sufficient market power to exploit consumers and squash competitors, to inhibit the economic system's ability to produce the social and political objectives that flow from a competitive economy. History suggests that even the most skilled and conscientious regulator – and Britain has been blessed with many such – is at a disadvantage in dealing with such firms. Several disadvantages, in fact:

- Information asymmetry – the regulated enterprise always knows more about its costs and its markets than does the regulator;
- Resource disparity – the regulated company generally has greater resources to devote to the regulatory process than does the regulator; [illegible]
- Regulatory capture – not in the vulgar sense of corrupting the regulator, but in the more subtle sense that requires the regulator to fear for the financial health of the companies he inevitably regards as his responsibility.

For these reasons, and because no regulator can duplicate the results of a competitive market, wherever possible it is good public policy to reduce the need for regulation by encouraging the growth of competition. In short, we want to reduce (or elevate!) dominant firms to the status of competitors, so that the long arm of the regulator can be replaced by the invisible hand of the market, where regulation already exists, and avoided where it is not yet in place.

That will achieve the following *social* objectives:

✓ Mobility – by ending the ability of a dominant firm to create barriers to entry, either by engaging in predatory or exclusionary tactics, competition opens the way for a new class of entrepreneurs to emerge.

✓ Distributional equity – competition permits companies to recover their costs, including a reasonable return on their investment, but no more; consumers cannot be exploited.

✓ Material prosperity – I know it is fashionable to think in terms of "happiness" as something distinct from material well-being, so forgive my old-fashioned emphasis on material prosperity, a social objective fostered by the competition that requires innovation and the production of a wide variety of goods and services.

✓ Fairness – absent extraordinary coercion by the state, no economic system can long survive if it is considered unfair, with opportunity reserved for the dominant class or firms.

So it is not unreasonable to suggest that the way to promote a variety of *social objectives* is to promote *economic* competition, rather than to shift to the use of the regulatory process to achieve social goals.

This is not the place to lay out all the details of a policy to promote competition. At earlier sessions we have made the case for coming down hard on cartel behaviour, which has no redeeming features. Here we can confine ourselves to pointing out that EU competition commissioner Neelie Kroes is on the right track when she encourages private parties to join her in enforcing prohibitions against exclusionary behaviour by dominant firms; that dominant firms cannot be allowed to impose pricing policies related less to economies of scale than to an intent to bar entry by achieving the equivalent of exclusive dealing and full-line forcing; and that Britain's example, set thanks largely to the Chancellor, of attracting talented and determined men and women to the business of enforcement is one that other nations should follow.

But we cannot stop there. Man does not live by bread alone; democratic societies have social objectives that cannot be achieved merely by reliance on competitive markets. There are the deserving poor, including those overwhelmed at times by forces of change not of their making and with which they cannot cope; there is the need for public goods that the market does not produce; there are the demands of decency that do not allow us to live comfortably in a world in which economists' computations of costs and benefits are the ultimate determinants of public policy; and there are the ever-present externalities that can be internalised only by bringing the force of law to bear.

These are legitimate concerns of politicians. It is the role of economists to inform them of the costs of achieving these various goal – of how many miles of new roads must be given up to pay for universal availability of a new drug; of the effect on incentives to work and take risks of a new tax to pay for some social programme, or of a scheme to redistribute income; of the trade-off between economic growth and a cleaner environment (yes there is such a trade-off, as much as politicians scrambling to be greener than green attempt to wish it away). But it is not for economists to decide how democratic politicians should react to their cataloguing of costs and benefits, other than to suggest that it is bad policy to obscure the true costs, as that undermines democracy itself.

And it is bad policy – the worst policy – to abandon both the enforcement of competition policy, and of regulation when dealing with dominant firms. Those prisoner to the often-but-not-always valuable teachings of what is called the Chicago School argue that all monopoly power is transitory and that, in the long run, technological change will result in an attrition of any such power. To which the proper response is, first, that the long run can be very long indeed, and while we wait for the attrition to start, large monopoly profits can be earned, and millions of consumers exploited; second, that the tools available to dominant firms are sufficiently powerful to enable them to strangle competitors at birth, and retain their grip on power almost indefinitely.

Consider the case of Microsoft, which has been able to withstand the assault of half-hearted enforcement authorities and maintain its grip on the market for operating systems for decades. The tactics it has used are many and varied, including a price structure that discouraged equipment manufacturers from installing competitive products, and are so effective that even Google, no lightweight, finds it must complain about Microsoft's latest effort to lever its operating-system monopoly into control of the search-engine market.

Which brings me to short answers to the complicated questions that have been put to us:

- Social and political objectives are best determined by politicians, not regulators or dominant firms.

- These objectives are best paid for by direct taxes, so that those deciding which objectives are worth pursuing are accountable for the cost of that pursuit. Otherwise, it becomes costless for politicians to satisfy their appetites for social justice by hiding behind the skirts of regulators.
- The optimal way to achieve a social objective varies with the objective: environmental goals are best achieved by imposing all costs of consumption on the consumer of the good or service, either through user taxes or by forcing suppliers to internalise the costs; distributional justice is best achieved by elected politicians, not appointed regulators, and through use of the tax system, not by a system of cross-subsidising consumer groups.
- Vigourous competition policy achieves many of the social objectives that are less efficiently achieved by the regulatory or legislative processes.

Thank you for your attention.