Life before Economic Regulation [1]

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Economic regulation in the UK is generally assumed to have begun in 1983, with the privatisation of British Telecoms and the creation of the telecommunications regulator (then Oftel, now Ofcom). But what was life like for UK economists interested in economic regulation before 1983? The following account of regulation before then is based on my own personal recollections and publications, drawing also on David Parker's impressive Official History of Privatisation Vol 1.

Nationalisation and marginal cost pricing

The period 1945-51 saw the nationalisation of many of the main industries in the UK, including coal, electricity, gas, rail, road haulage, iron and steel. The guidance given to the Boards was vague: for example, "make available coal in qualities, quantities and prices as seem in the public interest". They were to "break even taking one year with another". There were no formal government powers but there was much informal government involvement.

In the 1940s and 1950s, welfare economists such as Hotelling, Lerner and Meade urged marginal cost pricing. There was only limited questioning by other economists, such as Coase, Thirlby and Wiseman (who were arguably on the fringe of mainstream economics).

During the 1950s there were growing concerns about the performance and finance of the nationalised industries. The 1961 White Paper on the *Economic and Financial Obligations of the Nationalised Industries* introduced financial objectives for them. The 1967 White Paper on *Nationalised Industries: review of economic and financial objectives* set 9 economic performance targets, a test discount rate, and made marginal cost pricing official policy at last.

Turvey showed how marginal cost pricing could be applied in nationalised industries. My Ph D thesis in 1969 and subsequent papers applied mathematical programming and game theory to characterise marginal cost pricing with joint costs, common costs and state-dependent costs, as applied to US telecommunications, Birmingham airport charges, and weather-dependent water prices. In 1973 Catherine Waddams completed her thesis on marginal cost pricing in the gas industry. Many other economists, too, including Foster, Gravelle, Heald, Rees and Webb, explored the implementation of marginal cost pricing in the nationalised industries.

In reality, however, it was questionable whether the nationalised industries actually used marginal cost pricing. The 1976 National Economic Development Office (NEDO) *Report on Nationalised Industries* said they did not do so. James Callaghan reportedly said: "as Chancellor I couldn't care less".

The main problems of the nationalised industries were poor financial performance and inefficiency. The real problem was not that price did not equal marginal cost, it was that costs in general, including marginal costs, were too high.

The 1978 White Paper *The Nationalised Industries* confirmed financial targets, set a required rate of return on new investment, and let industries work out their own prices.

But there was a continuing deterioration in performance, documented by economist Pryke and various Monopolies and Mergers Commission (MMC) reports on the gas, electricity and coal boards. Parker notes a feeling that "the industries were out of control" and "We cannot go on like this".

New thinking, but not privatisation and economic regulation

The 1960s-1970s were a period of new economic thinking. New ideas included Austrian economics arguing for competition as a rivalrous discovery process, public choice theory, agency theory, incentives and property rights, the economics of regulation, and monetarism/deregulation/free markets from Friedman.

However, these were mostly US analyses, not then perceived as particularly relevant to the UK. And the UK political climate was not conducive to significant reform. During the 1950s-60s there was an all-party acceptance of the "mixed economy". The Conservative party concluded that large scale denationalisation was unrealistic, and by 1970 its aim was merely to "stop further nationalisation". In the early 1970s there were U-turns to bail out "lame ducks", more intervention, and a prices and incomes policy. The 1979 Conservative manifesto, under Margaret Thatcher, was to raise productivity in the nationalised industries, impose clearer financial discipline, and accept less government interference.

So nationalisation was seen as a problem, but denationalisation (later called privatisation) was not seen as the solution. Hence there was no interest in economic regulation of a privatised sector. The academic climate was, if anything, even harsher towards free-market thinking. My own perception, in preparing a monograph on *The Fallacy of the Mixed Economy*2 was that it was permissible to discuss the problems of nationalised industries and to propose competition, but that to mention denationalisation/ privatisation would be professional suicide.

The emergence and acceptance of privatisation and economic regulation

In 1979 Mrs Thatcher was elected Prime Minister. There were internal Conservative party discussions of denationalisation, but not publicly. However, some possible sales of public assets were publicly mooted, to raise revenue to meet the public sector borrowing requirement. To that extent some denationalisation was now Government policy. So it was at last possible to discuss denationalisation publicly and professionally, which I did in "Ten Steps to Denationalisation". I suggested that "the real task is not to control the industries but to control government itself3". Initially about half the nationalised sector might be privatised, with an MMC reference after five years to assess the situation. But there was no mention of regulation. Here as elsewhere, regulation was not the solution, it was the problem (in the US) and/or ineffective (in the UK).

In 1982 there was a Central Policy Review Staff (CPRS) study on *How to increase competition by privatisation or other means*. Parker says that it "set out a framework for privatising the monopolies and establishing new regulatory structures". In parallel, the Department of Industry was planning the sale of British Telecom, and had similar thinking on regulation. But this thinking was not public.

Later in 1982 the Government proposed to privatise British Telecoms and regulate it via Oftel. There was extensive internal Government debate on the nature of this regulation. The Department of Industry proposed a maximum rate of return scheme. Professor Walters, economic advisor to the Prime Minister, objected to this and suggested his own "output-related profit levy". I was asked to adjudicate. My February 1983 Report on *Regulation of British Telecommunications' Profitability* critically appraised the two schemes, but suggested a third scheme, now familiar as the RPI-X approach.

In reality, however, the Report was more than that. It was perhaps the first public discussion of economic regulation in the UK. In a sense, it was an attempt (with Michael Beesley) to provide a crash course in the relevant economics. Not drawing on marginal cost pricing, the test discount rate, welfare economics etc, but on Austrian economics, public choice, property rights, the economics of regulation etc. It emphasised the importance and feasibility of promoting competition in telecoms, and indicated the potential case for 'no explicit constraints', which could be relevant if sufficient steps were taken to increase competition. It was also an attempt to position the debate and policy for future privatisations. We followed this up with a paper on "Privatisation: Principles, Problems and Priorities4".

Jon Stern says that, until my Report, "the world of regulatory economics and policy [was] a small group clustered around discussion of the US regulatory system and rate of return regulation … since 1983 a closed world opened up". There were, of course, several economists active in the area before then. But it is debatable whether, in the UK before 1983, there was much if any discussion of "economic regulation" as we now know it.

The contribution of Professor Catherine Waddams

Since 1983, an increasing number of economists have analysed and developed economic regulation. In particular, there has been a welcome focus on how markets and regulation actually work. Catherine Waddams has been a leader among these economists. Her work includes researching and writing on productivity changes in gas and electricity, distributional effects, incumbent and entrant response, the impact on fuel poor, whether consumers switch to the best supplier, measures of fuel poverty, the impact of non-discrimination clauses, consumer response in regulated markets, consumer inertia in energy markets, collective switching, regulating residential energy markets, fairness in retail energy markets, etc. A particular interest and achievement has been the analysis of fairness and equity. Looking ahead, this seems one of the main issues to grapple with in economic regulation.

References:

1. Summary of a presentation at the Conference on The Objectives of Economic Regulation (Honouring the research of Professor Catherine Waddams), CCP UEA, Norwich, 16 Sept 2019. Copies of the slides available at http://competitionpolicy.ac.uk/documents/8158338/30201033/Session+3+-+Stephen+Littlechild.pdf/28612579-09d2-b436-ed11-70267be7e22b and https://www.eprg.group.cam.ac.uk/wp-content/uploads/2019/09/S.- Littlechild_Life-before-Economic-Regulation-UEA2.pdf

2. Littlechild S. C, 1978, “The Fallacy of the Mixed Economy: An ‘Austrian’ critique of recent economic thinking and policy”, London, The Institute of Economic Affairs, available at: https://iea.org.uk/publications/research/the-fallacy-of-the-mixed-economy

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4. Beesley M, & Littlechild S. C, 1983, “Privatization: Principles, problems and priorities”, Lloyds Bank Review, July, 1-20.