

Agenda

Advancing economics in business

Competition as a public policy tool: what is the evidence?

A key priority for the government is to increase UK productivity by extending competitive markets. Competition helps drive productivity by acting as a spur to managerial incentives and productive efficiency through ‘natural selection’ of firm entry and exit, and by promoting incentives to innovate. However, as Andrew Rees, Director, Analysis and Research, Consumer and Competition Policy, DTI, and Sasha Maguire, Economist, DTI, explain, recent evidence on these effects is perhaps less well known

The UK's competition framework is generally rated among the best in the world by independent surveys.¹ The Department of Trade and Industry (DTI) is responsible for setting the legislative and regulatory parameters, with enforcement conducted by two independent competition authorities: the Office of Fair Trading (OFT) and the Competition Commission. They are responsible for enforcing the provisions of the UK's competition legislation—the Competition Act 1998 and the Enterprise Act 2002—which are intended to promote a pro-competitive climate, and to increase transparency and independence in competition decisions.²

Use of competition as a policy tool is promoted across government by a Competition Forum. This group was recently established to bring together government departments and the independent competition authorities to promote a shared understanding of UK and EU competition issues, and to identify key competition issues for the future. It provides a channel for spreading the message about competition policy, the benefits of competition, and the role of the competition authorities.

Compelling evidence

Turning to the evidence, two recent studies commissioned by the DTI have sought to identify and illustrate the benefits from competition. In the first, conducted by a team from the University of East Anglia (UEA), a series of case studies were used to examine the effects of interventions in particular markets by the government and competition authorities, aimed at removing obstacles to competition.³ In the second study, consultants, LECG, reviewed the effect of competition and the use of market mechanisms in the delivery of public policy objectives.⁴

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Product markets

The UEA study took six markets for case study investigation. The case studies were selected where it was thought there would be benefits resulting from interventions by the government or the competition authorities to enhance competition in those markets and to limit the potential for the abuse of market power. The aim of the study was to examine the nature and scale of those benefits, and the side effects, good or bad, of the policy interventions.

In four of the case studies—opticians, passenger air travel, international phone calls and books—government intervened to liberalise and deregulate the markets. In two further case studies—new cars and replica football shirts—the competition authorities intervened to deal with excess pricing.

With the exception of opticians, where the result was less clear-cut, there were reductions in prices following pro-competitive interventions. With replica football shirts, prices fell by around 15% following fines imposed on a number of manufacturers for price fixing. Prices for new cars in the UK fell rapidly following an investigation by the Competition Commission in 1999–2000,⁵ although other factors are also likely to have contributed.⁶ Following the end of the Net Book Agreement in 1997, which gave publishers the legal right to set minimum

retail prices for their books, the price of popular books fell, book sales increased and, contrary to fears expressed at the time of deregulation, the number of titles also increased. Significant price reductions were experienced both in the economy air travel sector and in international telephony after those markets were liberalised.

The example of the EU aviation market illustrates how the combination of liberalisation and entrepreneurial activity can have dramatic effects

But competition is not just about price. Often firms will respond to competition by innovating and bringing new products and practices to the market. As competition can drive innovation, so can innovation and technological advances boost competitive pressure, as has been the case in the telecommunications sector. Although government policy may often be an important factor for change, it is often not sufficient. The UEA study concluded that there also needs to be a pool of resourceful entrepreneurs, capable of exploiting changed market conditions.

The example of the EU aviation market illustrates how the combination of liberalisation and entrepreneurial activity can have dramatic effects. Liberalisation of the European aviation market began in 1992 and was finally completed in 1997. The consequences in the market were profound. Liberalisation opened the way for the rapid development of low-cost airlines—in particular Ryanair and EasyJet—and the subsequent forced competitive response by the more traditional incumbents.⁷ The study showed that, between 1992 and 2003, and especially since 1997, average airfare prices fell. Particularly sharp price reductions were seen in lower-cost fares. Over the same period, the frequency of flights increased, as did the average number of operators competing on a route. Choice also increased as low-cost carriers diversified away from the more traditional hubs and operated between regional airports. Overall, the study shows, there have been substantial consumer benefits arising from liberalisation and the intensification of competitive pressure.

Many of the benefits to both consumers and producers of the work of the Competition Commission, OFT, sector regulators and the DTI in curtailing, preventing and deterring anti-competitive agreements and the abuse of market dominance are, predictably, difficult to measure. In particular, the dynamic benefits, from greater efficiency and innovation, are difficult to quantify, as are the

benefits to consumers from greater non-price competition in areas such as service quality and choice.

Other recent estimates suggest that consumer benefits from the activities of the Competition Commission can be considerable.

- Commission action in 2003 against overcharging by mobile phone operators is expected to save consumers between £325m and £700m over four years.⁸
- A Commission inquiry into four major banks uncovered overcharging of £725m over three years.⁹
- A recent report by the Commission found that consumers were being overcharged, annually, between £116m and £152m for the purchase of extended warranties on electrical goods.¹⁰ A number of remedies were suggested by the Commission which have been put in place by the DTI.

Policy delivery

The benefits of competition—for example, in terms of productivity improvements—are not exclusive to the private sector. Indeed, there is now a reasonably broad consensus that competition and the use of market-type mechanisms can be key features in the improvement of public service delivery. Evidence shows that this can be the case even in apparently unlikely policy areas.

New research commissioned by the DTI under the auspices of the Competition Forum and conducted by LECG has used case study material from government departments to investigate the use of competition and market mechanisms to achieve public policy objectives. The work examines the benefits from competition and considers the various factors which can make the use of competition a successful part of modern policy-making. The research looks at the case studies covering three types of market mechanism, also drawing on an extensive literature review:

- *competitive tendering*—its use in delivery of prison services;
- *user choice*—choice-based letting in social housing;
- *marketable permits*—the UK Emissions Trading Scheme (UK ETS).

Competitive tendering of prison services

Periodically, the management, or the design, construction and management, of prisons has been open to competitive tender by bidders from both the private and public sectors. This policy approach has been developed over a number of years and has been able to draw lessons from earlier (less successful) efforts in the

USA. The National Offender Management Service (NOMS) has run a number of tender competitions for prison contracts, including those for the management of prisons and for the building of new prisons. By learning from its own and others' experience, NOMS has been able to develop the tender process and management contracts to ensure considerable benefits. Cost reductions have been achieved, not only in the prisons where contracts have been tendered, but across the prison sector as a whole, as the competitive process applies cost-reduction pressures throughout. The introduction of private sector prison management has also resulted in innovations in work practices, in the use of technology, and in prison design. Again, these benefits have not been limited to the prisons directly affected, but have spread throughout the prisons managed in the public sector.

Choice-based letting in social housing

The successful introduction of choice into the allocation of social housing illustrates how the imaginative use of market mechanisms can bring benefits even in unlikely policy areas. Choice-based letting (CBL) brings an estate-agency-style approach to social housing. Where previously prospective tenants were allocated a property according to a bureaucratic process, CBL provides customers with information on the range of available properties and allows them to bid for the properties in which they are interested using variations on a points-based currency. Although still a relatively new policy, there is already evidence that CBL has reduced the amount of time that vacant properties lie empty, and has meant that tenants both remain longer in properties they have chosen and take better care of them.¹¹

UK Emissions Trading Scheme

The UK ETS has been developed as part of the UK's policy response to the challenge of climate change. It operates by setting a target for reductions in emissions of greenhouse gases (GHGs), and allowing polluting firms to buy and sell allowances to produce GHGs up to the target level. This system has clear benefits over a more prescriptive approach in which, for example, all firms are forced to reduce their emissions by a certain proportion to reach the same overall target reduction. By allowing trade in emissions allowances, the target is met by the most cost-efficient means. Those firms with a high cost of pollution abatement reduce their emissions by proportionately less and purchase the shortfall from firms which face a low cost of abatement and which consequently exceed their requirements and sell the excess. The results of the UK ETS thus far are that the government's five-year emissions reduction target was surpassed after only the first year of the scheme's operation, and this has been achieved in a cost-effective manner.

Conclusions

From these case studies, and other evidence, recent research has drawn key lessons for policy-makers in designing and implementing market-based approaches to realise benefits and minimise any pitfalls.¹² These lessons will be used by the government's Competition Forum as part of its strategy to highlight to departments the value of market-based approaches. It will help demonstrate the benefits of competition, and provide guidance on implementation issues and potential pitfalls, which is crucial if market approaches are to make an effective contribution to public policy.

Andrew Rees and Sasha Maguire

¹ KPMG (2004), 'Peer Review of Competition Policy', report prepared for the DTI and *Global Competition Review* 2005.

² The Competition Act 1998 prohibits anti-competitive agreements and the abuse of a dominant position. The Enterprise Act 2002 includes measures to criminalise cartels, ensure that merger decisions are taken by independent competition authorities according to a competition-based test, and allow the OFT and Competition Commission to conduct proactive market investigations.

³ Davies, S., Coles, H., Olczak, M., Pike, C. and Wilson, C. (2004), 'The Benefits from Competition: Some Illustrative UK Cases', DTI Economics Paper no. 9.

⁴ Hahn, R., Coombs, J., Kalmus, C., Razo, C. and Curry, K. (2005), 'Public Policy: Using Market-based Approaches', DTI Economics Paper no. 14.

⁵ Competition Commission (2000), 'New Cars: A Report on the Supply of New Motor Cars within the UK', Stationery Office, London.

⁶ Other factors include a pre-emptive move by manufacturers in anticipation of policy changes at European level.

⁷ Davies, S., Coles, H., Olczak, M., Pike, C. and Wilson, C. (2004), op. cit., p. 61.

⁸ Competition Commission (2003), 'Vodafone, O2, Orange and T-Mobile: Reports on References under Section 13 of the Telecommunications Act 1984 on the Charges Made by Vodafone, O2, Orange and T-Mobile for Terminating Calls from Fixed and Mobile Networks'.

⁹ Competition Commission (2002), 'The Supply of Banking Services by Clearing Banks to Small and Medium-sized Enterprises'.

¹⁰ Competition Commission (2003), 'Extended Warranties on Domestic Electrical Goods: A Report on the Supply of Extended Warranties on Domestic Electrical Goods within the UK—Volumes 1, 2 and 3'.

¹¹ See, for example, Hahn, R., Coombs, J., Kalmus, C., Razo, C. and Curry, K. (2005), op. cit., Table 10.7, p. 138.

¹² For example, attempts to cut costs in private sector prisons in the USA led to quality issues and some high-profile management failures. See Hahn, R., Coombs, J., Kalmus, C., Razo, C. and Curry, K. (2005), op. cit., pp. 80–82.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d.holt@oxera.com

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