AQA Economics A-level

Microeconomics

Topic 8: Market Mechanism, Market Failure and Government Intervention in Markets

8.7 Competition policy

Notes

Enhancing competition between firms through promotion of small business

The UK government has established the 'Red Tape Challenge', which aims to simplify regulation for businesses. It is especially aimed towards small businesses. This aims to make it cheaper and easier to meet environmental targets and create new jobs.

More information on this can be found here:
http://www.redtapechallenge.cabinetoffice.gov.uk/home/index/

Small and Medium Sized Enterprises (SMEs) are important for creating a competitive market. They create jobs, stimulate innovation and investment and promote a competitive environment.

Governments aim to improve access to finance and reduce barriers to entry, which will make it easier for smaller firms to enter the market.

Schumpeter, an economist, proposed the idea of 'creative destruction'. This is the idea that new entrepreneurs are innovative, which challenges existing firms. The more productive firms then grow, whilst the least productive are forced to leave the market. This results in an expansion of the economy's productive potential.

Deregulation and privatisation

By deregulating or privatising the public sector, firms can compete in a competitive market, which should also help improve economic efficiency.

Deregulation is the act of reducing how much an industry is regulated. It reduces government power and enhances competition.

Excessive regulation is also called 'red tape'. It can limit the quantity of output that a firm produces. For example, environmental laws and taxes might result in firms only being able to produce a certain quantity before exceeding a pollution permit. Excessive taxes, such as a high rate of corporation tax, might discourage firms earning above a certain level of profit, since they do not keep as much of it. This might limit the size that a firm chooses, or is able to, grow to.

Privatisation means that assets are transferred from the public sector to the private sector. In other words, the government sells a firm so that it is no longer in their control. The firm is left to the free market and private individuals.

For example, British Airways was privatised in the UK and now operates in the competitive market.

Free market economists will argue that the private sector gives firms incentives to operate efficiently, which increases economic welfare. This is because firms operating on the free market have a profit incentive, which firms which are nationalised do not.

Since they are operating on the free market, firms also have to produces the goods and services consumers want. This increases allocative efficiency and might mean goods and services are of a higher quality. Competition might also result in lower prices. However, firms which profit maximise in a competitive market might compromise on quality.

By selling the asset to the private sector, revenue is raised for the government. However, this is only a one-off payment.

The Royal Mail was privatised in the UK. This was done by allowing the Royal Mail to float on the stock market. At the offer price, the government owned 30% of the shares.

Competitive tendering for government contracts

The government provides some goods and services because they are public or merit goods, and they are underprovided in the free market. The government could contract out this provision, so that private firms operate things such as roads or hospital.

The firm which offers the lowest price and best quality of provision wins the government contract. This saves the government money, since the public sector can be bureaucratic and inefficient. The private sector has an incentive to reduce their costs, since they operate in a competitive market.

It also frees the government of maintenance, since the private sector might have the expertise and knowledge to fulfil the project and maintain the infrastructure.

This can be evaluated by considering how the private sector might not meet the specification of the contract. Moreover, the private sector firm might try and cut costs by lowering wages, and they are less likely to have social welfare as a priority.