Edexcel Economics (A) A-level

Theme 3: Business Behaviour and the Labour Market

3.6 Government Intervention

Detailed Notes

3.6.1 Government Intervention

The **Competition and Markets Authority (CMA)** work to promote competition for the benefit of consumers and investigate mergers and breaches of UK and EU competition law, enforce consumer protection law and bring criminal cases against individuals who participate in cartels. They are able impose financial penalties, prevent mergers taking place and force businesses to reverse actions already taken.

Controlling mergers:

- In the UK, mergers are assessed in terms of the specific circumstances of each case, considering whether there will be a **substantial lessening of competition** (SLC). The CMA will consider the likely competitive situation if the merger goes ahead compared to if it does not, and the merger will be approved if its potential benefits are greater than its cost.
- A merger is investigated if it will result in market share greater than 25% or if it meets the turnover test of a combined turnover of £70 million or more.
- The aim of preventing two large companies merging is so they do not **exploit their customers** by raising price, offering poorer quality service and reducing choice. It can prevent firms from gaining monopoly power.
- However, the problem is that **very few mergers are investigated** each year. The CMA can suffer from regulatory capture and may not have all the information necessary to make a decision.

<u>Tesco's takeover of Booker was allowed as the CMA believed the impact on competition would not be too high since supermarkets are in a hypercompetitive industry. However, the European Commission blocked the merger of Ryanair & Aerlingus in 2010 as they would control more than than 80% of all Europe flights from Ireland.</u>

Controlling monopolies:

Holding a dominant position in an industry is not wrong in itself but if the firm exploits this to stifle competition, they are deemed to be anti-competitive. Monopolies are allocative and productively inefficient and so it can be argued that they need to be controlled. Most of this regulation occurs for utilities, which are natural monopoles.

Price regulation:

- Regulators can set price controls to force monopolists to charge a price below profit maximising price, using the **RPI-X** formula. X represents the **expected efficiency gains** of the firms and the aim is to ensure firms pass on their efficiency gains to consumers. <u>This is used in the airport industry.</u>

- Arguably, a better system is **'RPI-X+K'**, where K represents the level of **investment**. This is used in the water industry and has allowed investment of £130bn.

- It gives an incentive for firms to be **as efficient as possible** as if they can lower costs by more than X they will enjoy increased profit. It **prevents excessive prices** and ensures that gains are passed onto the consumer.

- The problem is that it is **difficult to know where to set X** due to rapid improvement in technology and because any information on what the efficiency gains will be have to come from the firm, who could easily lie as there is **asymmetric information**. As a result, there may be sudden price falls or rebates for customers, for example the water industry was forced to cut prices by 10% in 2000.

- Moreover, **maximum prices** could be set where the price is equal to the MSC, ensuring monopolies are **allocative efficient**. However, it is difficult for governments to know where they should set the price as they do not know the exact allocative efficient output. It can also increase dynamic inefficiency as firms are unable to maximise profit so may not invest.

Profit regulation:

- In the USA, **'rate of return'** regulation is used where prices are set to allow coverage of operating costs and to earn a 'fair' rate of return on capital invested, based on typical rates of return in a competitive market.

- This aims to **encourage investment** and prevents firms from setting high prices. However, it gives firms an incentive to **employ too much capital** in order to increase their profits.

- It is also criticised since a reduction in costs will not improve the firm's situation and so there is **little incentive to be efficient**. As with 'RPI-X' it also means that regulators need sufficient knowledge of the industry and so will suffer from **asymmetric information.**

Quality standards:

- Monopolists will only produce high quality goods if this is the best way to maximise profits. The government can introduce quality standards, which will ensure that firms **do not exploit their customers** by offering poor quality.

- For example, the Post Office has to deliver letters on a daily basis to all areas and electricity generators are forced to have enough capacity to prevent blackouts.

- The problem is that it requires **political will and understanding** to introduce.

Performance targets:

- Regulators can introduce **yardstick competition**, such as setting punctuality targets for train operating companies based on the best-performing European train operators. It is also possible to split up a service into regional sectors to **compare the performance of one region against another**; this is used in the water industry.

- They could set targets over price, quality, consumer choice and costs of production. It will help firms to improve their service and lead to **gains for customers.**

- The problem is that firms will **resist the introduction of targets,** so again it requires political will and understanding. They will also attempt to find ways to **meet targets without actually improving**, for example changing train timetables to prevent trains officially arriving late.

- Other firms will **fail to meet their performance targets** and so there will be no improvements. Network Rail failed to deliver on the performance targets for their long distance sector in 2013-14. The government need to ensure that fines and other deterrents are strong enough that firms at least work to ensure targets are met.

Other types of regulation for monopolists:

- **Windfall taxes:** These are taxes that are imposed after the event has occurred, for example after monopolists have made extremely high profits. It can discourage monopolists from making excessive profits and/or encourage them to reinvest them. However, it is not a long term solution and firms may begin to underreport their profits.

- **Breaking up the monopolist:** The government can split the monopolist up into competing units, which should lead to lower prices and profits and greater consumer choice. However, this may cause a loss of economies of scale and mean that prices could even rise. There is likely to be little impact of splitting a monopoly up into two firms and lobby groups will make this very hard for the government to do

- **Subsidies:** In order to achieve allocative efficiency, the government could subsidise monopolies. This will reduce their MC and encourage them to produce where the cost to society (MC) is equal to the value society places on it (P). Taxing the profits of the monopolists would allow the government to regain some of that money. However, giving subsidies to private sector monopolies will be very politically unpopular. It also requires accurate knowledge of costs and revenue curves and knowing where the allocative efficient output would be.

- **Self-regulation:** When monopolists come under threat of regulation, they tend to suggest that they should regulate themselves through codes of practise. This is beneficial to government as it means they don't have to pass legislation and industries police themselves rather than having to pay workers to enforce regulation. However, this tends to be a weak way of regulating firms as firms will aim to minimise the amount of changes they have to make and continue to maximise profit.

- Reducing barriers to entry and using merger policy will prevent monopolies being formed in the first place. Nationalisation can help to protect consumers in the case of a natural monopoly, whilst privatisation can help to increase efficiency.

Promoting competition and contestability:

Promotion of small business:

- The government can give **training and grants to new entrepreneurs** and encourage small businesses through **tax incentives or subsidies**. This will increase competition since there will be more firms within the market, and will offer a chance for more firms to join.

- It **increases innovation and efficiency**, since new firms are likely to provide new products and incumbent firms will no longer be able to be X-inefficient.

- The Red Tape Challenge aims to decrease regulation, particularly for small businesses. There are also schemes, such as the Enterprise Investment Schemes and Seed Enterprise Investment Scheme, which provide tax relief for people who buy shares in small companies to help them grow.

Deregulation:

- This is the **removal of legal barriers to entry** to a previously protected market to allow private enterprises to compete. This will **increase efficiency** in the market by allowing greater competition as more firms can enter and conduct more activities than they could before. The Deregulation Act of 2015 aims to continue deregulation.

- The government can also **privatise** industries, which will allow for competition in the market.

- However, it can have some negative effects, leading to **poor business behaviour**. Licenses for specific industries are necessary to ensure standards are upheld. Some have argued that the deregulation of financial markets was a major contributor to the financial crisis in 2008.

Competitive tendering:

- The government has to provide certain goods and services because they are merit or public goods but this does not mean that the state has to be the producer of all these goods and services. Goods, such as the sheets in NHS hospitals, are **produced by the private sector and then bought by the public sector.**

- A similar thing can be done with services; the government can **contract out the provision of a good or service to private companies** e.g. private firms could be employed to run hospitals. These are called Private Finance Initiatives (PFI)

- **Competition can be introduced** into the market as the government will request competitive tenders by drawing up a specification for the good or service and inviting private firms to bid for the contract to deliver it. The firm offering the lowest price wins the contract, subject to quality guarantees.

- This helps to **minimise costs** for the government and **ensures efficiency** by allowing for competition in the market. The private sector will have **more experience** running the projects, so it is likely they will be better managed.

- However, it may not always be the most cost effective way and the process of collecting bids is **costly and time-consuming**. The private sector may not aim to maximise social welfare in the same way the government would and could use cost-cutting methods that **reduce quality**.

It is important that they prevent firms undertaking **anti-competitive practices**, such as collusion and predatory pricing. The Enterprise Act (2002) means firms engaging in these practices can be fined up to 10% of worldwide annual sales and those who organise cartels can face up to five years in prison and unlimited fines. In 2011, the 9 supermarkets in the UK were found to be fixing the price of milk and cheese products and Tesco alone was fined for £10 million. The problem is that it is very difficult to prove overt collusion and almost impossible to prove tacit collusion.

Protecting suppliers and employees:

Restrictions on monopsony power:

- Monopsonists are able to exploit suppliers by reducing prices. The government can prevent these by passing **anti-monopsony laws** which make certain practices illegal and can introduce an **independent regulator** who will force monopsonists to buy fairly.

- **Fines** can be put in place for those who exploit their power and **minimum prices** may be introduced to ensure suppliers are paid a fair amount. **Self-regulation** can also be used, but this is weak.

Workers' rights:

- The government protects employees through **health and safety laws, employment contracts, redundancy processes, maximum hours at work and the right to be in a trade union.** The government can also encourage firms to draw up **codes of conduct** relating to employment practice.

- The problem is that if workers' rights are too strong, employers will be **unwilling to take on new workers** due to the extra cost of employing these workers.

Privatisation and nationalisation:

- Privatisation is the sale of government equity in nationalised industries or other firms to private investors. The aim is to revitalise inefficient industries but can sometimes lead to higher prices and poor services.

- Nationalisation is when a private sector company or industry is brought under state control, to be owned and managed by the government.

Advantages and disadvantages of privatisation:

- It encourages **greater competition**, which reduces X-inefficiency and ensures low prices and high quality as firms realise they need to be competitive.
- Managers become more **accountable**, since they know poor performance will mean a fall in share prices and/or shareholders wanting them to be replaced.
- In both the long and short run, it can **reduce the public sector net cash requirement** (PSNCR) as the initial sale of shares raises revenue for the government and they no longer have to cover any of the firm's losses.
- It **reduces government interference** which some see as a benefit in itself. This also means that firms can **invest with greater certainty**, instead of worrying about change when a government is elected every 5 years.
- An ideological argument is that it puts **utilities into the hands of the people**, since they can own shares. Workers will be more motivated as they know their hard-work will be rewarded by high dividends.
- On the other hand, when there are natural monopolies it may be fairer for the government to own the firm since they won't **abuse their monopoly position**.
- Some people argue that **industries such as electricity, water and transport are important** because they directly affect the success of other industries, and so therefore it makes more sense for the government to own them in order to coordinate them properly.
- There are problems over **externalities and inequality.**
- Some argue that it **negatively affects that the PSNCR** as firms are under-priced when they are sold and the government no long receives a firm's profit.

<u>Between 1994 and 1997, the railway industry was privatised. This has seen a rise in passenger satisfaction and a growth in investment. Season tickets have risen with inflation but standard single fairs have risen by 200%.</u>

Advantages and disadvantages of nationalisation:

- **Investment is needed for the long term**, but in a private company investment is only short term as shareholders will see no benefit from long term investment. This may lead to a poor quality of service.
- In the case of a **natural monopoly**, it is better for monopoly to be run by the state as they aim to maximise social welfare rather than a private business who will maximise profits.
- The government will **consider externalities**.
- The government will guarantee a **minimum level of service** for people who suffer the risk of being cut off from the service, due to the lack of potential profit from providing for them.
- Some say it would be **dangerous** to allow key strategic industries to fall into private hands as this could have disastrous effects for the country.

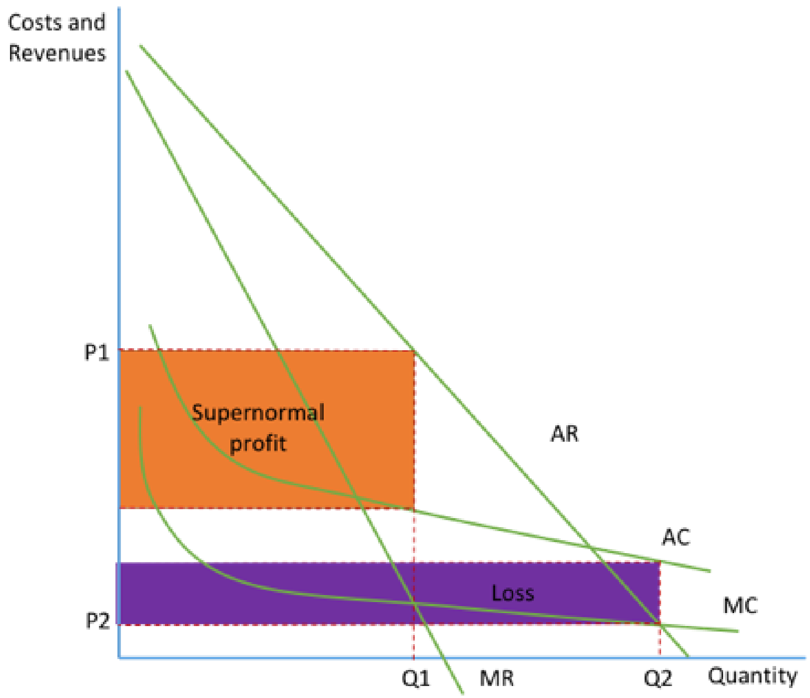
- However, nationalised industries suffer from the **principal-agent problem and moral hazard,** as managers know that any loss they make will be covered by the government.
- They will experience **X-inefficiency** and this could cause higher prices for consumers, especially since the industry will become a monopoly.
- They will be **influenced by government's decisions** and the government may not have enough money to invest.

<u>Post WWII brought high levels of nationalisation and this is known as the 'golden age, a period of high growth before a period of stagflation that led to privatisation of these same industries. It became apparent that they suffered from high losses and were X-inefficient.</u>

<u>The NHS is a nationalised industry which suffers from a lack of funding and a lack of competition, both of which lead to poor quality. They also suffer from uncertainty as spending on the NHS changes every five years with the new government; this causes problems and is something Jeremy Hunt has tried to change.</u>

Natural monopolies:

Natural monopolies bring about the question of nationalisation. It is argued that if the industry is likely to end up as a monopoly it is better for the consumer if that monopoly is controlled by the government, who will maximise welfare. If the firm is private and decides to profit maximise, it will produce where MC=MR and therefore produce at P1Q1 and make supernormal profit of the orange area. However, if it was nationalised the firm would instead aim to maximise welfare and so would produce where AR=MC, the allocative efficient output. This would mean they produce at Q2P2 and would make a loss of the purple area. The nationalisation leads to higher output at lower prices but causes a loss for the industry, which the government would need to cover.



3.6.2 The impact of government intervention

Impacts:

- Governments are able to **prevent monopolies charging excessive prices** and aim to **limit their profit.** They try to ensure that **consumers pay fair prices, receive a good quality service and have a lot of choice** through different methods of regulation and target setting. High regulation may force some firms out of the industry, which would reduce choice.

- They can increase **efficiency** in a market by increasing competition and contestability. By regulating prices, they ensure a business keeps their costs low and so prevent X-inefficiency. They try to increase **dynamic efficiency** by encouraging investment. However, if the government regulates too strongly, they can **push costs up** and led to inefficiency.

- If the government runs a business, in theory, they should **reduce prices and increase quality** as they aim to benefit consumers. A public sector business is likely to be **allocative efficient,** as they aim to maximise social welfare. They will see lower costs due to **economies of scale**. However, the government may suffer from **X-inefficiency** as they have no incentive to be efficient due to the lack of competition. This may push up prices and reduce the quality of a good; the private sector may have expertise and knowledge which the government might not have. The government are likely to offer **less choice,** since there is only one company producing the good.

- Government intervention on the whole tends to be limited because of the political power of large firms and industries as a whole. They are able to lobby the government and set up pressure groups.

Limits:

Regulatory capture:

- This occurs when the regulator is captured by the firm/industry they are regulating. The fact that the regulator will often meet with the firm's employees will mean they become **more empathetic** and able to '**see things from their perspective'**, which will remove impartiality and weakens their ability to regulate.

- Large corporations can **invest huge amounts** in learning how to play the system and in gaining the support of their regulator. It also is likely that the regulator will have **worked in the sector** for many years, as these people will have experience and knowledge of the industry. As a result, they will have **personal connections** with those that they are regulating and this makes it difficult for them to be unbiased.

- This is an example of **government failure**, and argues that government regulation is not the most effective method of achieving competition and efficiency.

- One example is the alleged capture of HMRC by Vodafone, who negotiated a tax reduction from £7bn to £1bn in 2009-10.

Asymmetric information:

- This is where regulatory bodies have to **use information provided to them by the industries** when setting price targets etc. It is in the industry's best interest to maximise their profits and so may provide inaccurate or limited information, meaning regulators are unable to set correct targets, prices etc.

- As a result, **government failure** may occur if regulation such as RPI-X or quality standards are not set correctly. The government will be unable to regulate the companies accurately.