Edexcel Economics A-level

Unit 3: Business Behaviour

Topic 4: Government Intervention to Promote Competition

4.1-4.2 Government intervention to protect consumers, suppliers and employees

Notes

- **Promoting competition through:**
    - **Preventing anti-competitive practices, and controlling mergers and takeovers**

- The Competition and Markets Authority (CMA) is the main competition regulator in the UK. The key aims for competition policy are to promote competition and ensure markets are efficient. They also protect consumer interests by keeping prices low and widening consumer choice.

- The competition authorities investigate potential mergers between two large firms, if they would dominate the market by merging.

- If the merger (or takeover) is deemed to create a larger firm with monopoly power, it is likely to be prevented.

- These are two mergers that have been in the news recently:

  Kraft shares soar on Heinz merger - BBC News

  Why mega-merger is so important for Shell - BBC News

- **Government intervention to control monopolies:**

- Governments intervene in the market to control monopolies and prevent the abuse of monopoly power. This is because of the potential for market failure, and loss of consumer surplus, that can result from a monopoly exploiting the market.

- The transfer of wealth from consumers to producers is not necessarily considered to be an economic problem. However, the reduction in overall economic welfare that results from monopoly power is a disadvantage.

- **Price regulation**

  Governments can prevent monopolies charging consumers excessive prices, which might result in a loss of allocative efficiency.

For example, they might use RPI-X, which is a form of price capping. This is usually used for privatised industries, such as the utility companies. OFGEM, which regulates the gas and electricity markets, OFWAT, which regulates the water industry, and ORR, which regulates rail services, are able to employ a price cap as part of their regulation.
The value of X is the amount in real terms that the price has to be cut by. RPI might be 5% for a particular year. If X is set at 2%, then the firm can only increase prices by 5% - 2% =3%.

In the water industry, firms are limited by RPI +/- K. K represents how much investment the firm needs to undertake.

The advantages of RPI-X include that firms could increase profits by cutting their costs by more than X. This encourages them to be more efficient, since they have an incentive to lower their costs. It also encourages competition in the market, which can prevent the firms abusing their monopoly power.

However, it is hard to determine what the value of X should be. Moreover, it could limit how much profit a firm can make, which might in turn limit how much investment they do.

There is also the risk of regulatory capture. This is when regulators start working in favour of the firm.

- **Profit regulation**

Governments can control the profits that firms earn by ensuring they are not excessive. In the UK, firms have to pay corporation on any profits they earn. The UK government reduced the rate of corporation tax from 21% to 20% in April 2015. This was with the aim of encouraging investment.

- **Quality standards**

Additionally, regulators can observe the quality of the goods and services of the firm. For example, in the gas and electricity markets, regulators ensure the elderly are treated fairly, especially in the colder months. Governments ensure minimum standards are met.

- **Performance targets**

The government sets targets on organisations, such as schools, to ensure a minimum target is being met. This aims to regulate their quality. The NHS, which has monopoly power, also has performance targets, such as reducing waiting times. It helps the firm to focus on increasing social welfare.

- **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.

- ## 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.

Employee protection

- **Trade union power:** If trade unions are pushing for higher wages above the market equilibrium, the labour market is likely to be more flexible. Trade unions can also increase job security. Higher wages can be demanded by limiting the supply of labour, by closing firms, or by threatening strike action. Higher wages could cause unemployment, however. Trade unions can counter-balance exploitative monopsony power.

  These could attract workers to the labour market, because they know their employment rights will be defended. However, the limits on workers, such as limiting their ability to strike, might cause some people to withdraw from the labour market.

Trade unions aim to protect workers, secure jobs, improve working conditions and try and achieve higher wages.

If trade unions try and increase wage rates too much, firms might no longer be able to afford to employ workers. This could cause them to close down or reduce the number of workers they employ. Some workers might prefer a low paid job rather than be without employment.

In a market where an employer has monopsony power, workers are only paid W2, and only Q2 number of workers is employed. This is the profit maximising level.

A trade union aims to increase marginal revenue product in the market, as well as increase wages to the level of MRP (W3). This is to stop the exploitation of labour. The perfectly competitive level of employment and wage rate is W1, Q1.