OFFICE OF FAIR TRADING

Government in markets

Why competition matters – a guide for policy makers

Contents

One of the Office of Fair Trading's functions, under section 7 of the Enterprise Act 2002, is to provide information and advice to Government on competition and consumer issues. As such, we have a dedicated Advocacy Team whose role is to strengthen our relationships with Government departments and other stakeholders to help preserve and promote competition in markets and to increase awareness of consumer protection issues. This includes ensuring that regulation does not unnecessarily or disproportionately restrict competition, but instead achieves the best possible outcomes for consumers.

The aim of this guide is to provide a framework for analysing Government's interaction with markets, and for policy makers who want to understand the different ways in which Government can affect markets. It may also help provoke a more open debate about the long term effects of Government intervention, both positive and negative.

1. Executive summary

At their most basic, markets are a mechanism for allocating resources. Well-regulated, competitive markets can maximise consumer welfare, and, by raising economic growth, also increase total welfare.

When markets work well, firms thrive by providing what consumers want better and more cost-effectively than their competitors. As such, effective competition provides significant benefits for consumers through greater choice, lower prices, and better quality goods and services. Competition also provides strong incentives for firms to be more efficient and innovative, thereby helping raise productivity growth across the economy.

Left to their own devices, however, markets will not necessarily deliver the best outcomes for consumers, companies or Government. In order to address this, Government sets legal and institutional frameworks for markets and companies to operate in. That is, it puts in place rules and regulations that determine appropriate conduct of firms and individuals, and the institutions necessary for enforcing them. Markets thus do not exist independently of Government, which has a legitimate role in intervening in and shaping them.

Government also intervenes more widely in markets to achieve other policy goals and correct market failures. The way in which it chooses to do so, however, is crucial to both the effectiveness of its interventions and their consequences.

This guide sets out the rationale for Government intervention in markets and demonstrates that for these interventions to be effective in the long term, their impact on competition needs to be a central consideration. The guide then sets out some of the major ways that Government intervenes, both in setting market frameworks and through its wider impact on markets. It also identifies ways that policy makers can spot and minimise unintended consequences that impact on effective market dynamics beyond the short term. It includes case studies of the impacts in practice.

Government's role in markets

Government can affect markets either through direct participation (as a market maker or as a buyer or supplier of goods and services), or through indirect participation in private markets (for example, through regulation, taxation, subsidy or other influence).

Government frequently has a choice between traditional instruments and market-based approaches. There are pros and cons associated with all types of Government intervention. Many, if not most, intervention can have unforeseen consequences. Failure to address indirect costs and possible spillovers can result in a less effective policy and impose unnecessary economic costs.

Government intervention can also inadvertently benefit regulated industry rather than the wider public (regulatory capture), promote inefficiency because of restricted competition or underplay the role of consumers by concentrating purely on the supply-side of the market.

In general, measures that directly limit competition in the market will not be the best instruments. Regulation of, for example, price, entry and exit, or allowing anti-competitive mergers and agreements between firms, are generally rather blunt measures and can be less transparent than other measures such as setting product standards or introducing taxes or subsidies. While these may also have effects on competition, they can typically be designed in a more focused and transparent way.

A major challenge for policy makers is in identifying the 'hidden costs' of competition restrictions. While the policy benefits of particular interventions may be clear, the longer-term effects on competition can be far harder to predict.

Key points for policy makers:

At a minimum, the aim for policy makers should be to minimise the distortions to markets, subject to achieving the desired policy objective. That is, where Government has a reason for intervening in markets, it should try to do so in a way that avoids unintended consequences as far as possible.

In assessing the effectiveness of existing or proposed Government interventions in a market, policy makers should consider the associated costs and benefits, including the impact on competition within a market.

Some interventions are more likely to distort or restrict competitive markets, either intentionally or inadvertently. To identify these, policy makers should consider the following questions:

- Does the intervention affect the possibility of entry and exit in a market – for example by granting exclusive rights to supply, limiting the number of suppliers, or significantly raising the cost to new firms of entering the market?
- Does it affect the nature of competition between firms in a market, either through direct restrictions (such as price or product regulation) or by reducing the incentive for firms to compete strongly?
- Does it affect the ability of consumers to shop around between firms and exercise choice – for example, does it raise costs of switching?

When a proposed intervention is likely to adversely affect competitive markets, policy makers should consider possible alternatives which might be less restrictive of competition. Government can often play a beneficial role in stimulating competition in markets, either through setting up market mechanisms, or, for example, through its wider role in procurement.

Part A: Principles

2. Introduction

Government and markets are inextricably linked. Government sets the legal and institutional frameworks within which markets operate. It raises taxes based on the activities of businesses and consumers in markets. It has an interest in market outcomes and the way these are distributed between different groups and firms in society. Sometimes Government wants to encourage the market to deliver particular products and services for wider social benefit. At other times it wants to discourage market products because of their wider negative effects. These links and tensions are an intrinsic part of a modern market economy.

Context

Recent developments in financial markets and the economic downturn have cast a new light on Government's role in markets. Public trust in the ability of markets to deliver efficiency and stability has been challenged. Governments across the world have recently intervened in markets more heavily than in many previous years.

In the UK, Government has sought to help minimise the impact of the financial crisis and economic downturn on both consumers and firms, and to help the economic recovery and secure future economic growth. Intervention has come in the form of extra spending on large capital infrastructure projects (such as Crossrail and broadband cables) as well as investment in innovation and education. Government has also intervened to help the economy respond to longer term challenges such as energy and climate change through, for example, providing subsidies for renewable energy production.

Government's more active role in markets coincides with a need to spend carefully. The 2009 Budget estimated that between 2007/08 and 2009/10 Government expenditure will have increased by 15 per cent, while tax receipts will have fallen by 10 per cent.[1] Any intervention needs to be well designed and fit for purpose to ensure that the highest value for money can be achieved and that damaging unintended consequences are avoided.

This may mean a renewed focus on the delivery of public services, such as healthcare, education or benefits, which have traditionally been provided directly by the public sector through an actual or near monopoly.

At the same time, policy makers around the world are facing potential turning points in how we meet the challenges of, for example, fuel supply and alternative energy sources, environmental degradation, and food supply and security. As a global community we are facing fundamental questions on how we adapt existing and new markets to changing circumstances.

1 HMT (2009a), pages 231 and 238.

The role of the Office of Fair Trading (OFT)

The OFT's mission is to make markets work well for consumers. This happens when companies are in open, fair and vigorous competition with each other for consumers' custom. Our powers under competition and consumer law not only allow us to tackle anti-competitive behaviour by companies but also to address public restrictions on competition.

One of the OFT's functions, under section 7 of the Enterprise Act 2002, is to provide information and advice to Government on competition and consumer issues. As such, we have a dedicated Advocacy Team working to strengthen our relationships with Government departments and other stakeholders to help preserve and promote competition in markets and to increase awareness of consumer protection issues. This includes ensuring that regulation does not unnecessarily or disproportionately restrict competition, but instead achieves the best possible outcomes for consumers.

This guide is structured in two sections. Part A sets out the rationale and some of the principles of Government involvement in markets. It also offers some key points for policy makers to consider when assessing interventions. Part B provides more detail on specific ways in which Government can intervene, and highlights some of the competition impacts of these different policy approaches. There is, necessarily, an element of repetition between the parts of the guide, but this has been avoided where possible.

3. The role of competition

Key points:

- Effective competition in properly regulated markets can deliver lower prices, better quality goods and services and greater choice for consumers.
- Competition can create strong incentives for firms to be more efficient and to invest in innovation, thereby helping raise productivity growth.
- Policy makers should aim to protect and promote competition in markets in order to capture the benefits of markets for consumers and society as a whole.
- However, markets if not adequately regulated can potentially harm consumers.

Competition is a process of rivalry between suppliers seeking to win business. Competition is sometimes assumed to focus only on price, but suppliers can also compete in other ways, for example by developing the quality of existing products, by using their entrepreneurial skills, or investing in research to develop new goods and services.

Some of the processes of competition can also be applied within the public sector. For example, hospitals might compete for patients within a framework where consumers can choose between different providers.

For the most part, open competitive markets are the best way of maximising consumer welfare and raising economic growth.

Competition:

- **Drives firms to improve their internal efficiency and reduce costs.** Cost minimisation allows firms to deliver the same goods and services to consumers, but at lower prices. This will attract a greater number of consumers and the firm will gain a larger market share.
- **Provides incentives to firms to adopt new technology.** Early adoption of technology and/or new techniques and processes helps firms minimise their costs.
- **Provides incentives to firms to invest in innovation.** Investment in innovation allows firms to improve the quality of their existing products and/or develop new products and services to better suit the changing needs and preferences of consumers.
- **Reduces managerial inefficiency.** Competitive pressures from other firms and new entrants lead firms to look for better, more efficient ways to organise their business. Lack of effective competition could lead firms and managers to operate with inefficient business models and technology as firms are unlikely to lose profits.

Competition is not just about the behaviour of firms within a given market. Significant benefits are derived from the entry or the threat of entry by new firms and the exit of inefficient firms. New firms bring with them new ideas and better, more efficient ways of producing goods. They also create incentives for existing firms to improve their performance and develop their products, in order to avoid losing market share and being forced to exit the market. Reducing entry and exit barriers can therefore be a powerful mechanism in driving and maintaining competition.

Over the long term, competition, through improving firm-level efficiency and incentivising investment in innovation, generates higher rates of productivity growth resulting in increased economic growth and greater prosperity.[2]

Domestic competition and international competitiveness

Competition in domestic markets also increases the degree to which British firms and products can compete in international markets. It does this in several ways:

- Domestic competition in the traded goods and services sectors can directly improve competitiveness by driving exporting businesses to become more efficient.
- Where goods and services are not directly traded, they often provide important inputs for other firms. Competition in these markets reduces input costs for exporting businesses.
- Even where non-traded goods and services do not provide direct inputs for exporting businesses, competition can still play a role in creating the conditions for attracting inward investment and mobile foreign labour and capital.

Evidence on the impact of competition

Reforms introduced by the UK Government aimed at reducing entry barriers, such as market liberalisation and interventions by competition authorities, have increased innovation and productivity in the UK.[3] Entry or the threat of entry by new firms increased the incentive for existing firms to innovate or adopt new techniques in order to avoid the loss of market share. It also caused those less efficient firms to exit from the market, thereby raising economy-wide productivity levels.

It has been estimated that 20 to 40 per cent of total factor productivity differences between eight OECD countries could be explained by the level of firm entry and exit.[4]

Increased competition in the UK has been considered a major factor in explaining the narrowing in the productivity gap between British and German manufacturing.[5]

There are also many examples of the impacts of increased competition within particular markets. Box 3.1 considers the case of the European aviation market.

2 Aghion et al. (2008).

3 For more detail on the link between competition and economic growth, see OFT (2007c).

4 Nickell, (1996). Total factor productivity is a measure of the efficiency with which economic inputs are converted into outputs.

5 Crafts and Mills (2001).

Box 3.1: Case study of the benefits of competition: EU Aviation

Until the 1990s, the European aviation market was heavily regulated and dominated by national flag carriers (such as British Airways and Air France). Air travel within Europe was governed by bilateral agreements between Member States.

A series of reforms led to lessened state support for the incumbent airlines. In 1993 any airline with an operating licence from any EU Member State was allowed to operate any route within the EU, and fare discussions were no longer bilateral. The deregulations led to increased competition and significant innovation, in particular through the entry of low-cost airlines such as Ryanair and EasyJet. The increased competition has benefited consumers in two main ways:

- lower prices: the lowest (nominal) non-sale fare fell 66 per cent between 1992 and 2002
- flight frequency: between 1992 and 2002 the European flight frequency increased by 78 per cent.

The increased competition has also led to substantial regional growth, with many low-cost airlines favouring smaller, regional airports as opposed to the main ones. The increased frequency of flights has not led to a worsening of safety: between 1992 and 2001 the number of reportable accidents per revenue hour fell by around 50 per cent.

Further examples of the benefits of competition include:[6]

- The prohibition of the Net Book Agreement (an agreement between publishers not to supply books to retailers that price below the publisher's net price) in 1997 led to a dramatic reduction in the price of popular paperback fiction, with discounts on bestsellers and 'multi-buy' offers such as two-for-one now regularly being seen.
- Following the OFT investigation in 2002 into price fixing by manufacturers and retailers of replica football kits, the choice of outlets increased and prices decreased by some 15 per cent.
- The deregulation of the retail spectacles market since the 1980s not only led to an increase in the range and quality of spectacles (from 200 frames in 1986 to more than 3,000 and the development of features such as anti-scratch coating and tinted lenses), but an improvement in the quality of the service (including increased opening hours, speed of service, and immediate consultations).
- The deregulation of international telephone calls has provided consumers with greater choice of providers and significant decreases in the price of UK international calls, down 90 per cent over the decade to 2002.

6 DTI (2004).

Unintended consequences of competition and the importance of consumer behaviour

While the overall benefits of competition are clear, if competition is not adequately regulated it can cause significant consumer detriment. Box 3.2 sets out the case of the UK retail electricity market which experienced a number of problems following the introduction of competition and choice to the market.

Box 3.2: Competition and choice in the UK retail energy market

In 1998/9 the UK domestic retail electricity and gas markets were fully opened to competition, allowing customers to switch between competing energy suppliers. The introduction of competition provided incentives for suppliers to lower prices, improve their services, and increase customer choice through a greater range of tariffs and payment mechanisms that better suited customers' needs.

However, the experience of retail energy liberalisation also demonstrates the need for ongoing monitoring and enforcement of consumer protection measures when introducing competition into new markets, and highlights the risk that some customers may suffer difficulties, particularly during the early stages of competition.

For example, shortly after the introduction of competition, some consumers experienced a number of problems as some energy suppliers used aggressive selling techniques to attract new business. There were complaints concerning doorstep selling, sale agents using misleading information about the potential savings customers could achieve if they switched, and customers being switched without their consent. In 2002 the energy regulator, Ofgem, imposed a penalty of £2 million on London Electricity for breaching selling regulations. Following this the industry introduced a self-regulatory code and the number of complaints about mis-selling fell sharply.

More recently concerns have been expressed about whether the proliferation of choice in the market is benefiting consumers. Research carried out by Ofgem showed that 70 per cent of consumers find the number of tariffs on offer confusing, and just over half find it too hard to work out whether they would be saving anything if they switched. Ofgem has taken a number steps to address this, for example through proposed license conditions requiring suppliers to provide more information to customers aimed at helping them compare tariff offers.[7]

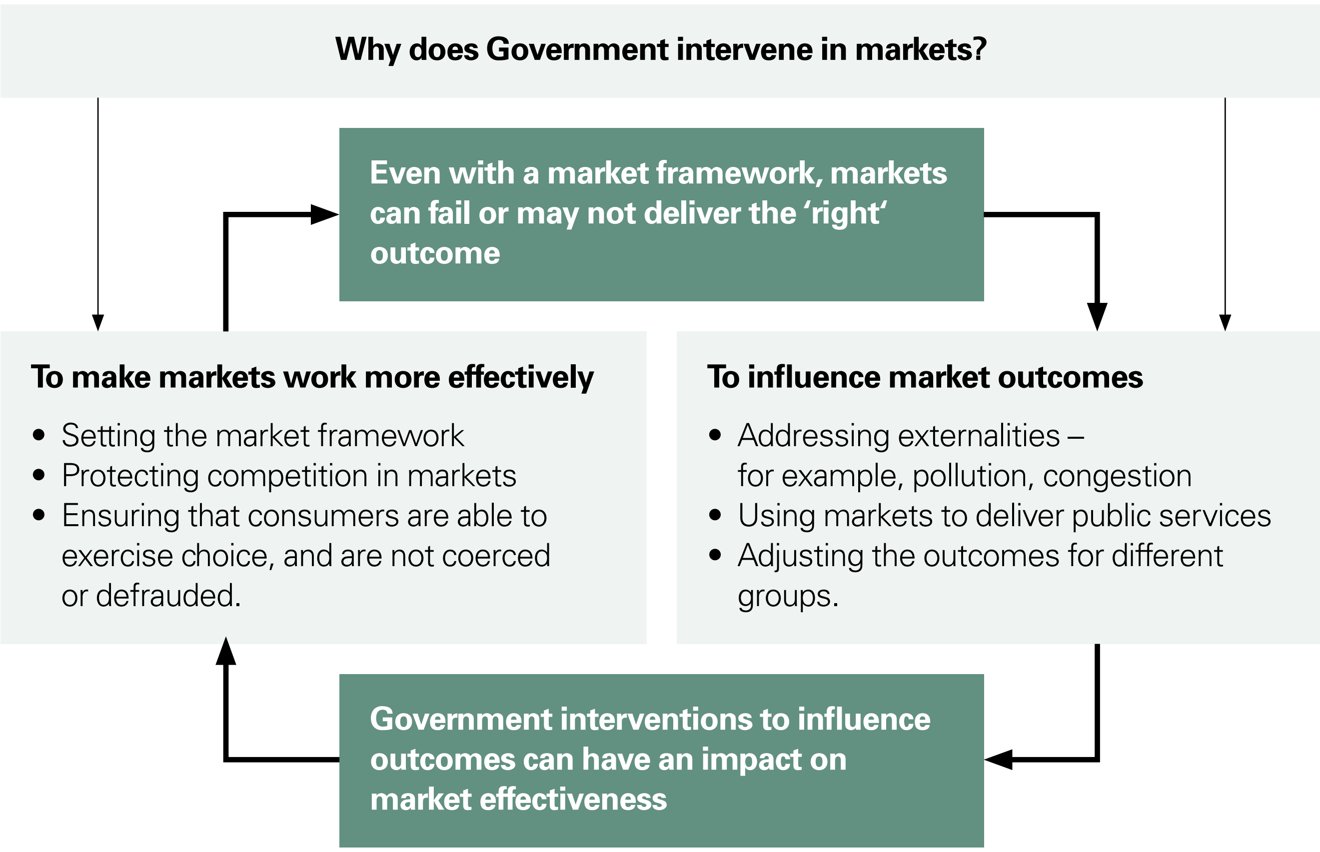
7 Ofgem (2008), 'Energy Supply Probe - Initial Findings Report'.

4. Reasons for intervention

Competition by itself may not necessarily deliver the best outcomes.

Markets do not always work effectively, and as a result Government plays a crucial role. Government interventions in markets can be divided into two broad types: to set the framework within which markets operate, and to influence market outcomes. This is illustrated in Figure 4.1.

Figure 4.1: Government's role in setting frameworks and influencing outcomes



Setting market frameworks

Key points:

- Government plays a vital role in creating the basic framework within which fair and open competitive markets exist. It sets the rules and regulations that determine the appropriate conduct of firms and individuals and creates the institutions necessary for their enforcement. Without these basic rules and regulations, markets could not operate effectively.
- A competition and consumer law framework is essential to ensure firms are unable to exploit market power and consumers are protected from unfair trading practices.
- Poorly regulated markets can be detrimental to consumers. It is important that Government creates effective rules and regulations that generate the best outcomes for consumers.
- Policy makers should take care that their policies do not unnecessarily infringe on the established competition and consumer law framework as the consequences for consumers might be significant.

Government plays a vital role in creating the basic framework within which fair and open competitive markets can exist. At a very basic level Government is responsible for establishing the 'rule of law', creating property rights, ensuring contracts are upheld, and setting up the necessary institutions for the proper functioning of markets. This includes the establishment of a competition and consumer law framework that governs the way firms and individuals should behave when operating in markets.

Competition law prevents firms from making anti-competitive agreements, and ensures 'dominant' firms are not able to exploit their position to distort market outcomes, by, for example, restricting the entry of new firms and charging higher than competitive prices. It also restricts mergers which could lead to a substantial lessening of competition.

Consumer law aims to protect consumers from scams, frauds and other potentially abusive practices. It sets out consumers' rights in relation to the firms they deal with and aims to ensure that traders act fairly and honestly towards their customers.

Without this competition and consumer law framework consumers would be vulnerable to exploitation by firms and could potentially withdraw from markets altogether. Annexe A sets out the UK's competition and consumer law framework in more detail.

It is important that policy makers take care that their policies do not unnecessarily infringe on the established competition and consumer law framework, by for example encouraging voluntary agreements between firms that might breach competition law.

Wider market interventions

Key points:

- Government frequently intervenes to achieve particular social objectives, such as poverty reduction or improvement of the health and well-being of citizens.
- Government also intervenes where markets have failed to help stabilise the economy following an unexpected disturbance, or to help speed up the economic recovery following a downturn. This has recently been observed following the financial crisis and economic downturn.
- There are costs and benefits associated with any Government intervention in a market, and it is important that policy makers consider all of the costs and benefits of a policy intervention. Distortions to competition can often be easily overlooked by concentrating on more direct costs.
- Distortions to competition are not immediately visible as it usually takes time for the full consequences to emerge.

Even with the existence of a basic framework to ensure markets function effectively, Government frequently intervenes in markets either:

- because of market failures, or
- to achieve particular social objectives, such as reducing poverty or to improve the health and well-being of individuals.

Interventions to address market failure

'Market failures' are situations where markets are prevented from working efficiently to provide the goods and services that are demanded by consumers and in the desired quantities. Markets can 'fail' as a result of public goods, externalities, information problems and market power.

Public goods

There is a consensus that free markets would not provide certain public goods and services, such as national defence. This is because once the good is paid for and produced it is difficult to exclude others from benefiting from it; as a result, no individual or group is willing to pay for it.

Externalities

It is common for free markets to produce too much or too little of a good or service from a societal point of view. This can happen when the costs of production to an individual firm, or the costs of consumption to an individual consumer, do not include the wider costs or benefits to society.

A common example is pollution. Where firms are not required to pay for any environmental damage, they have little incentive to curb production and therefore produce too much from a societal perspective. Conversely, education would be underprovided if left to private markets; whilst a well-educated population increases the general welfare of the rest of society, this would not be taken into account by individuals when making consumption decisions.

Information problems

In some markets it can be difficult for consumers to be certain about the quality of a good or service before they buy it. This can disadvantage suppliers of better quality products because they will find it difficult to convince customers to pay the higher prices which are necessary to cover any additional costs the producers have incurred. In some extreme cases this mismatch could lead to the collapse of the market: if consumers cannot judge the quality of a product, they may end up buying nothing.[8]

Government can intervene to help overcome these problems and empower consumers to make informed choices. For example, Government can require appropriate labelling showing the provenance of food products or the energy efficiency of electrical products. Government can also address the problem by educating consumers to better understand complex products and services, such as financial products.

Market power and natural monopolies

In almost all markets, some suppliers can exercise a degree of market power. Competition law exists to ensure that suppliers do not abuse this market power at a cost to consumers.

In the extreme, there are some markets where it is more efficient for only one firm to produce the good rather than multiple firms. This typically occurs where there are large initial costs associated with setting up the infrastructure needed for production and delivery – for example, water and energy networks. Where there is a single monopoly firm, Government may also choose to regulate market power more directly – for example, through ex ante price controls.

Interventions to achieve wider policy objectives

Government also intervenes to achieve social objectives including:

- changing consumer behaviour where such behaviour has adverse effects on society or because of fears over harm for the individual
- the co-ordination of private investment where lack of information or confidence about the future development of a market threaten its success
- the development of private markets to address a long-term shift in the economy or the political landscape.

Government may come under pressure to intervene during cyclical downturns. In such cases it is argued that inaction by Government could lead to the failure of otherwise viable firms, job losses and a loss of skills. Such arguments conclude that this in turn would prolong the time it takes for the economy to recover.

Government may also intervene to ensure the security of particular supply chains that are considered essential for the functioning of the economy. For example, much has been made recently about ensuring the security of food and energy supply in the face of potential future world shortages. Similar arguments have often been used with respect to defence.

8 Akerlof (1970).

5. Types of intervention

Figure 5.1: Ways in which Government participates in markets

Direct Government participation in markets		Indirect Government participation in markets	
Acting as a supplier	**Acting as a buyer**	**Taxes and subsides**	**Regulation and influence**
Through direct provision of goods and services to the public, and as collector and holder of public sector information	Through competitive tendering	Through changing the costs of goods and services	Through statutory requirements, information campaigns

Depending on the reason for Government intervention and the characteristics of each particular market, there are a number of types of intervention that the Government can choose from.

In many markets, the Government participates directly as a provider or as a buyer (procurer) of goods and services. Where this is not the case the Government can also influence firms indirectly through taxes, subsidies and regulation, and increasingly through 'softer' forms of influence on businesses and consumers. This is summarised in Figure 5.1 above.

Direct participation

Government participates directly in markets for two main reasons: to provide public goods and services that free markets would be unlikely to provide at an appropriate level (see Externalities on page 12) and to benefit from the commercial value of public sector assets. Government as a supplier is considered in more detail in Chapter 12.

Government is also a significant buyer of goods and services from the private sector. Estimates of the total size of public procurement in the UK range from around 11 per cent to 18 per cent of

GDP.[9] Government buys from the private sector in order to deliver public services and also to carry out its functions, for example the provision of offices, IT equipment and research services. Government typically procures goods and services through a competitive tendering process. Potential suppliers bid for contracts, and the contract is awarded to the firm that best meets the specified criteria and provides the best value for money. Public procurement is considered in more detail in Chapter 11.

Indirect participation

Government usually intervenes indirectly where private markets exist but produce side-effects that have an impact, either positive or negative, on social welfare. When a negative side effect exists, for example pollution from car exhausts, Government can choose to discourage its production (for example, vehicle tax) and/or its consumption (for example, petrol or road tax). Such measures alter the incentives faced by producers and consumers. When a side-effect exists that is beneficial to society and should be encouraged, for example research and development, Government can choose to subsidise it thereby encouraging production and/or consumption. The role of Government taxes and subsidies are considered in more detail in Chapter 8.

Government can also choose to intervene through regulation: to ensure minimum standards of health and safety, or that harmful ingredients are not allowed in food, for example. Government can also shape the direction of markets through its ability to influence the economy via targets and policy statements. For example, Government has set challenging carbon emission reduction targets and made commitments to purchase low carbon technology, thereby sending a strong signal to the market that it should invest in low carbon markets and technology. The roles of Government as a regulator and as an influencer are considered in more detail in Chapters 7 and 9 respectively.

Types of intervention

There are costs and benefits associated with all types of Government intervention. It is important to ensure that the appropriate tool is selected so Government can achieve its intended policy objective with minimal effect on competition, choice and the effective workings of the market.

In both direct and indirect participation, Government has a choice between more traditional instruments and market-based approaches. This is set out in Figure 5.2.

Figure 5.2: Types of Government intervention

	Traditional instruments	**Market-based approaches**
Providing public services	Direct provisions	Competitive tendering User choice
Influencing private markets	Regulation Tax and subsidy	Trading schemes Self-regulation

9 OFT (2004).

6. Key points for policy makers

Box 6.1: Unintended consequences of regulation[10]

Japan regulates the techniques and materials that can be used in home construction with the aim of preserving the national character of the country's housing stock. However, this means that construction companies cannot increase efficiency through standardisation, which would lower the price of housing, and consumers cannot themselves decide whether they want to pay the aesthetic premium.

Germany regulates retail trading hours with the aim of protecting workers and making Sundays special. But this, together with high minimum wages and zoning laws has helped keep German retail productivity 15 per cent below US retailing productivity, which in turn has resulted in higher prices for consumers.

For all interventions, it is important that a wide range of costs and benefits are considered. Failure to address indirect costs and benefits and possible spillovers can result in a less effective policy and unnecessary economic costs across a range of markets.

Risks to competition from Government intervention

Importantly, distortions to competition can be easily overlooked as policy makers concentrate on more direct costs of an intervention, particularly as it usually takes some time for the consequences of restrictions to competition to manifest.

By intervening in a way that works 'with the grain' of markets, Government can minimise distortions to competitive markets whilst still achieving their policy goals.

Table 6.1 summarises some of the ways Government intervenes and their potential risks to competition. These instruments and risks are considered in more detail in Part B of this guide.

10 Beardsley and Farrell, (2005).

Table 6.1: Reasons for intervention and risks to competition

Objective	Reason for intervention	Instruments	Risks to competition
Changing consumer behaviour	Some features of consumers' behaviour may have adverse effects on society (for example, alcohol misuse or obesity).	Education Minimum standards Information Tax Regulation Setting prices Restrict supply	Restricting the supply of particular goods or setting prices can significantly dampen competition and raise prices for all consumers. Consumers are heterogeneous, consuming and behaving differently from each other whereas supply-side and price-setting interventions can be blunt and have an impact on everyone.
Supporting specific markets, locations or products	Government may wish to develop specific markets or products to take advantage of long-term shifts in the economy and changes in consumer trends. Without intervention these markets and products may not exist (for example, low carbon technology).	Subsidies Regulation Targets Policy announcements	Risks from 'picking winners'. Competition may be distorted if Government support has differential effects across firms or creates barriers from entry by giving advantage to existing firms. Government support may distort the allocation of resources across the economy. The economy may end up producing goods that are not demanded by consumers. Private markets are better for allocating resources.
Restructuring industry	Orderly restructuring aims to reduce the negative impacts of disturbances to the economy, economic downturns or changes in trends. Necessary to help firms survive, preserve jobs and prevent the loss of skills.	Regulation Market creation Subsidies Tax breaks	Support to industries via subsidies may allow inefficient firms to remain in the market and does not reward financially sound firms. May dampen incentives to innovate. Blocks normal entry and exit to market, which is a key part of the process of competition. Facilitating mergers has a potentially large negative long-run impact on competition.
Security of supply	Ensure the security of particular supply chain considered essential for the functioning of modern industrialised economy.	Subsidies Tax breaks Regulation	Creating monopoly suppliers, facilitating mergers, and /or protecting existing firms from competition can have a significant impact on consumers and the rest of the economy. Many of these markets are inputs into other products. This will drive up prices and reduce innovation.

Assessing impacts on competition

Impacts on competition may be hard to identify or quantify, particularly as they tend to emerge in the long term. Unintended distortions to competition will be costly for consumers. To identify interventions more likely to distort or restrict competitive markets, the following key points could be considered:

- Does the intervention affect the possibility of entry and exit in a market – for example, by granting exclusive rights to supply, limiting the number of suppliers, or significantly raising the cost to new firms of entering the market?
- Does it affect the nature of competition between firms in a market, either through direct restrictions (such as price or product regulation) or by reducing the incentive on firms to compete strongly?
- Does it affect the ability of consumers to shop around between firms and exercise choice – for example, does it raise costs of switching?

Conducting competition assessments during the policy making process can be a useful way of identifying unintended consequences. It is important that this assessment takes place during the early stages of policy development. This will minimise the risk of developing a policy that is ill-designed or realising late in the process that unless changes are made, significant adverse effects on the market will render the proposed policy less effective.

In general, measures that directly limit competition in the market will not be the most effective instruments. Regulating price, entry or exit, or allowing anti-competitive mergers and agreements between firms, are generally rather blunt measures and can be less transparent than other interventions such as setting product standards or introducing taxes or subsidies. While these measures may also have effects on competition they can typically be designed in a more focused and transparent way.

Similarly, horizontal measures that do not discriminate by location, industry or firm type, such as skills strategies and assistance with access to capital, are less likely to distort competition than interventions aimed at particular markets or firms. And where interventions can be more easily removed, or are explicitly time-limited, the long-term impacts on competition may be reduced.

Minimising impacts on competition

When a proposed intervention is likely to adversely affect competitive markets, policy makers should consider alternative options that could achieve the same policy goal but with fewer adverse effects.

In particular, policy makers should ensure that ways to influence consumer behaviour (the demand-side) are considered alongside instruments to change business behaviour (the supply-side). Influencing consumer behaviour is, on the whole, far more challenging for Government than changing business behaviour: it is more complex and takes time for the effects to become visible. For this reason, there can sometimes be an incentive to intervene primarily on the supply-side, when demand-side measures might ultimately be more effective.

Intervening on the demand-side and attempting to instigate cultural change may have longer lasting effects. They are also less likely to give rise to black market type problems. Using taxation to increase the cost to consumers is also likely to be less distortive of competition.

Policy makers should ensure that timely progress checks are scheduled to evaluate the effectiveness of an intervention – so-called 'sunset clauses'. For example, the US Civil Aeronautics Board Sunset Act of 1984 ended 40 years of close regulation of airline routes and fares, resulting in increased competition and lower prices.[11]

Creativity is often needed in thinking about possible alternative measures which might be less restrictive of competition. It may not always be immediately obvious that there are alternatives to more traditional 'command and control' approaches. For example, some local authorities have introduced a system of choice-based lettings for provision of social housing. This market solution increased the transparency of the process and has reduced vacancy rates (properties are re-let more quickly). In addition, social tenants are more likely to occupy a property that meets their needs and surveys have shown a high degree of satisfaction among tenants.[12]

11 Beardsley and Farrell (2005).

12 DTI (2005).

Part B: Government interventions

The following chapters consider different instruments of intervention in more detail. Each chapter contains a brief summary of when the particular instrument is commonly used, how it is used, and provides some indications of the possible competition implications.

7. Regulation[13]

Key points:

- Regulation plays an important role in helping markets function effectively, and ensuring that they support wider policy goals.
- Regulation can also distort competition – particularly by affecting the scope for new firms to enter markets, and the ability and incentives of firms to compete with each other.
- It is important to identify possible unintended consequences of regulation. Carrying out a competition assessment of new policy can help with this.
- To reduce distortions, policy makers should seek to minimise regulation, subject to achieving the wider policy objective.
- Market-based approaches can sometimes be an effective alternative to direct regulation, harnessing markets in a way that fits with wider policy goals.

Some degree of regulation is essential for modern markets to function. Buyers and sellers need to have confidence that the contracts they sign will be upheld and that property rights are clearly defined.

Regulation can have beneficial effects for society. It often provides important protection, for instance regulations that protect the health and safety of workers. Regulation also has a potentially important role in protecting consumers, for example, through licensing of approved suppliers.

Regulation typically consists of a set of rules administered by the Government to influence the behaviour of businesses and, consequently, economic activity.[14] In this sense the term 'regulation' captures a wide range of Government actions, from primary legislation setting market frameworks through to detailed regulations imposed and enforced by specialist thematic and sectoral regulators.

There are examples where distortions resulting from regulation are not negative. For example, competition law explicitly constrains the behaviour of firms in the market to ensure that consumers are not harmed by abuse of market power.

13 More detailed guidance on competition assessment and the impacts of regulation is provided in OFT (2007a).
14 OECD (2007).

Box 7.1: Entry controls on pharmacies in the UK

In 1987 control of entry regulation was introduced to reduce costs to the NHS. Prior to this, pharmacies were reimbursed under a system that generously supported low-volume pharmacies. This encouraged the opening of small pharmacies, which led to escalating costs to the NHS. Rather than changing the remuneration system, control of entry was introduced.

The entry control regulation meant that pharmacies were licensed based on an assessment of need, and businesses wishing to enter the market or expand their number of existing sites were required to buy existing pharmacies. A reassessment of the licence is required even for pharmacies wishing to relocate within a very small geographical area.

The OFT conducted a market study of retail pharmacy services in 2002/03.[15] The study found that the control of entry regulations:

- restricted consumer choice and convenience in terms of location of pharmacies and opening hours
- restricted competition on 'over the counter' medicines
- provided blunt incentives for pharmacies to compete on additional customer services, and
- resulted in consumers paying £25-30m per year more for over the counter medicines than if competition were freer, and cost businesses an estimated £16m in compliance costs, and the NHS approximately £10m a year in administrative costs.

As the remuneration system that caused the problem in the first place has changed, the OFT recommended removal of the restrictions so that all registered pharmacies with qualified staff would be able to dispense prescriptions.

Following the market study, the Department of Health introduced a package of measures to exempt certain pharmacies from control of entry regulations, including pharmacies open more than 100 hours per week. This has encouraged new entry into the market.

Key points for policy makers

One of the biggest challenges for policy makers is to identify unintended consequences of regulations. From a competition perspective, the aim should be to impose the minimum regulation required to achieve any policy aim.

Regulation almost invariably creates some distortion of competition which can be detrimental to consumers. Policy makers should:

- have a clear efficiency rationale for intervention, and
- where intervention is warranted, minimise the distortion of competition subject to achieving the goal.

Completing a competition assessment helps to analyse the potential impacts of regulation on competition.[16] The competition assessment is part of a formal regulatory Impact Assessment, and identifies four ways in which regulations can affect competition, as set out in Box 7.2 .

15 OFT (2003).
16 OFT (2007a).

Government uses a wide range of instruments to regulate markets, including permits, quotas, quality standards and price controls. As a broad guide, it is useful to distinguish between:

- regulations on parameters of price and quantity (including direct constraints on entry into a market), and
- regulations on product characteristics, standards or quality.

Regulations on price, quantity and entry will typically place a direct restriction on competition in the market and have a negative effect on competition. For example, imposing a minimum price for a product stops firms competing for consumers on the basis of price. A restriction on the number of suppliers in a market (for example, through a licensing framework) reduces the competitive pressure on existing firms from the threat of new rivals taking market share.

Regulations on product characteristics, standards and quality will generally impose fewer direct restrictions on competition. But they can have important indirect effects. For example, setting a minimum product standard can remove certain goods from a market (that is, those that fall below the standard) even though some consumers may wish to buy them. Similarly, quality regulations can raise costs of entry, which discourages potential new rivals from entering the market.

Firms in most markets also compete on product quality and other characteristics, not just on price, and regulation of standards will affect this wider process of quality competition and innovation. In some situations in which consumers find it hard to gauge quality in a market, product standards can actually enhance competition by focussing it in areas that consumers can compare and act upon.

Rather than regulating to influence outcomes directly, Government can sometimes use market-based mechanisms to try to achieve its policy objectives. For example, spectrum trading is increasingly used as an alternative to administrative spectrum pricing in the communications sector.

A further issue for policy makers to be aware of is that of 'regulatory capture', when regulation ends up benefiting the industry regulated rather than the wider public. The main problem for policy makers here is their information disadvantage. In order to design a policy, information is frequently needed from firms, who may have an incentive to strategically provide information that will ensure beneficial regulation from their perspective. Here, market-based instruments tend to have an advantage over command-and-control approaches, as the amount of information needed ex ante by policy makers is lower.[17]

17 Helm (2002).

Box 7.2: Summary approach for assessing competition impacts

In any affected market, would the proposal:

1. Directly limit the number or range of suppliers?

This is likely to be the case if the proposal involves:

- the award of exclusive rights to supply
- procurement from a single supplier or restricted group of suppliers
- the creation of a form of licensing scheme, or
- a fixed limit (quota) on the number of suppliers.

2. Indirectly limit the number or range of suppliers?

This is likely to be the case if the proposal significantly raises the costs:

- of new suppliers relative to existing suppliers
- of some existing suppliers relative to others, or
- of entering or exiting an affected market.

3. Limit the ability of suppliers to compete?

This is likely to be the case if the proposal:

- controls or substantially influences
  – the prices(s) a supplier may charge
  – the characteristics of the product(s) supplied, for example by setting minimum quality standards
- limits the scope for innovation to introduce new products or supply existing products in new ways
- limits the sales channels a supplier can use, or the geographic area in which a supplier can operate
- substantially restricts the ability of suppliers to advertise their products, or
- limits the suppliers' freedoms to organise their own production processes or their choice of organisational form.

4. Reduce suppliers incentives to compete vigorously?

This may be the case where a proposal:

- exempts suppliers from general competition law
- introduces or amends an intellectual property regime
- requires or encourages the exchange between suppliers, or publication of information on prices, costs, sales or outputs, or
- increases the costs to customers of switching between suppliers.

8. Subsidies and taxation[18]

Key points:

- Subsidies and taxes affect competition by changing the costs of some businesses, and hence influencing their production decisions.
- This can have positive effects. For example, subsidies can be used to increase financial support for high growth small businesses, and taxes can be used to reduce environmental pollution.
- However, subsidies and taxes can also create entry barriers in a market and allow firms to build and exploit market power.
- In designing subsidies, policy makers should consider carefully both the degree of competition in the market, and the way in which different approaches might affect this competition to minimise the potential negative impacts on competition.
- Subsidies may constitute state aid and require legal cover. The competition assessment should be complementary with the state aid analysis.

Taxes are primarily a source of revenue for Government to fund its activities and services. Taxes can be indirect and levied on transactions, such as VAT, that do not vary with the income or status of the consumer, or direct such as income tax, which varies with income and other characteristics, such as whether a person has children.

Common types of subsidy include direct grants, tax exemptions, capital injections, equity participation, soft loans, and guarantees. Support can also involve providing economic advantages, for example allowing a firm to buy or rent publicly owned land at less than the market price, or by giving a firm privileged access to infrastructure without paying a fee.[19]

Taxes and subsidies can be used to influence the incentives and behaviour of private firms. There are several reasons why taxes and subsidies might be used in this way, including:

- To address market failures: common examples include the subsidy of education, innovation, and low-carbon and environmentally friendly goods or the taxation of pollution.[20]
- To address cyclical difficulties: subsidies might be used to temporarily support companies in financial trouble, particularly when their collapse would have wide-ranging

18 More detailed guidance on the competition effects of subsidies is given in OFT and HM Treasury (2007).

19 EC DG Comp (2008).

20 Related to this is the argument about economies of scale: for new (here, environmentally friendly) products to reach a high enough level of market uptake to make a difference, a critical mass needs to be developed. The Government can help in 'priming' the market by sponsoring the development and dissemination at early stages.

systemic consequences (such as the recent support for the UK banks) or when firms are generally financially viable but temporarily cannot access finance.

- To achieve wider social objectives: the Government may choose, for reasons of equity, to subsidise disadvantaged regions, areas, or groups. Equally, taxes can be used to redistribute income between groups.

Key points for policy makers

Both taxes and subsidies change the behaviour and incentives of firms, so may well have an effect on competition and market outcomes.

Taxes

Typically, taxes tend not to raise significant competition concerns, because they apply generally and are not targeted at particular firms. In some cases where taxes are specific, for example, environmental taxes or taxes on particular products or services, the competition effects may be more significant. In these cases the analysis would be similar to that of subsidies set out below.

A benefit of using taxation over other policy measures is that revenue raised can be used to reinforce policy objectives. For example, cigarettes can be taxed in order to reduce consumption: the revenue generated can in principle be used for education campaigns to further reduce consumption and the negative effects on society. In comparison, raising the minimum price of a product, whilst having a similar impact on consumers, would have the effect of transferring income from consumers to firms rather than from consumers to Government.

Subsidies

Subsidies can have important effects on competition, particularly where they have a differential impact on firms in a market. Whether or not a subsidy falls within the scope of European state aid rules, Government should make sure that the benefit of giving aid outweighs the potential costs of distorting competition.

The first risk to competition is that the subsidy increases the potential for anti-competitive behaviour by firms. This might be the case if the subsidy results in the recipient firm significantly increasing its market share to a level where:

- it can act independently of competitive constraints
- there is consolidation amongst competitors that either reduces competition or increases the risk of collusion, or
- entry barriers are raised so that potential future competition is prevented.[21]

A second risk is that the subsidy might undermine the mechanisms that ensure efficiency in the market. For example, the recipient firm could be under less financial pressure to be competitive or a subsidy may mean that an inefficient firm stays in the market. Alternatively, competitors not in receipt of aid could be forced to leave the market, or forced to take drastic action to ensure short-term survival at the expense of long-term prosperity.

Further risks include that significant sums of money might be spent by market participants in seeking subsidies, or that subsidies could distort firms' investment and R&D decisions.[22]

21 OFT and HMT (2007).

22 OFT (2005).

Box 8.1: Airline subsidies and the case of Aer Lingus

In 2001 the European Commission decided not to allow more state aid to airlines. The Belgian national carrier Sabena went bankrupt shortly afterwards. The Irish national carrier Aer Lingus faced a similar future, but despite being denied state aid and facing increased competition from RyanAir, it managed to cut costs by 30 per cent over a two-year period, became profitable, and expanded its route offering.

Some subsidies will also distort or threaten to distort intra-community trade. Where subsidies constitute state aid, they will require legal cover which may mean seeking forward approval from the European Commission.

The thresholds for meeting state aid tests of distorting competition and affecting intra-community trade are very low. However not all aid is illegal. A general block exemption regime exists which allows specific subsidies: in favour of SMEs, for R&D, innovation, training, regional development, employment, environmental protection, as risk capital, and for promoting entrepreneurship.[23]

In addition, the Treaty allows for Government to provide subsidies to failing firms in the form of rescue and/or restructuring aid.[24] Any aid granted by individual member states which is found to be incompatible with the Treaty will be reclaimed.[25]

Even where there are no intra-EU effects, it is important to minimise the potential side-effects of a subsidy. To do so, policy makers need carefully to consider both the design of the subsidy and the market in which the recipient firm operates.

Government should be wary of supporting industries or firms to carry out activities for which there appears to be limited consumer demand – the risk is that, despite the subsidy, consumers continue to ignore the product. Intervening to influence consumer demand may be a less wasteful way of achieving the same end.

Similarly, no matter how worthy the cause, supporting individual firms and industries could lead to the displacement of other activities, particularly where resources are scarce. Finally, if Government does choose to intervene it is typically better to introduce horizontal measures that do not discriminate by location, industry, or firm. Overall, these tend to be less distortive.

A subsidy is more likely to cause competition concerns if it is designed to be very large, be provided to only one or a few firms in the market, affect the recipient's average rather than fixed costs, or occur more than once.[26]

23 OFT and HMT (2007).

24 EC DG Comp (2009).

25 EC DG Comp (2008).

26 OFT (2004).

Subsidies will generally cause less distortion if there is strong competition in the market. Distortions are most likely to be significant if the market is concentrated, there are barriers to entry, the firms in the market are of markedly different sizes,[27] products are not highly differentiated[28] or if firms in the market compete on R&D.

Further information on how to assess the competition effects of subsidies can be found in the OFT and HM Treasury 2007 publication 'Guidance on how to assess the competition effects of subsidies'.[29]

Subsidies in the downturn

Government subsidies to struggling firms may be particularly important in the current economic climate. Such subsidies typically help failing firms through an orderly liquidation or provide assistance for struggling firms to restructure in order to survive in the longer term. During the recent financial crisis Government subsidies played a particularly important role in avoiding systemic collapse of the banking system.

There are significant risks to competition from this type of intervention. Recessions allow the economy to scale down or cease inefficient and wasteful activities and allow resources and skills to be redirected to other activities that have greater potential for growth (so-called 'creative destruction').

By not allowing this process to take place, Government may be rewarding inefficient firms and dampening competition. Financially sound firms are not rewarded for their efficiency and are likely to perform worse than if the failing firms were allowed to exit the market. Unsubsidised market participants will find it hard to compete with the inefficiently low prices supported by a subsidy. At the extreme, subsidising a failing firm may force more efficient firms to exit the market. Analysis of five firms receiving rescue and restructuring aid has indicated that recovery as a result of the subsidies appears to occur at the expense of competitors.[30]

Over the long term this may affect firms' incentives to invest in innovation and become more efficient.

There may, however, be some positive effects (in addition to saving jobs in the short term). Industry innovation may be sustained if the recipient firm is a market leader, or the recipient firm's overcapacity may be reduced, which benefits all firms in the market.

27 OFT (2004).

28 Assuming products are close substitutes, the non-recipient firms may be unable to lower their price to compete with the recipient firm, and will thus lose market share and, in the worst case, even be pushed out of the market.

29 OFT (2007b).

30 London Economics (2004).

Box 8.2: State Aid to Northern Rock

In August 2007, Northern Rock plc began to experience extreme funding difficulties as a result of a liquidity shortage in the wholesale money markets.

Starting in September 2007, the UK Treasury granted guarantees backed by state funds on existing and new accounts in Northern Rock, as well as financial assistance to address short-term liquidity needs. These rescue aids were subsequently followed by the bank being moved into temporary public ownership in February 2008. Northern Rock published a provisional restructuring plan in March 2008 which included details on the repayment of the loans and guarantees made by the Bank of England and the Government; and a gradual exit from the wholesale funding markets, in favour of increased activity in the retail deposits market. In February 2009, the Government announced that a new business strategy had been agreed for Northern Rock. To enable Northern Rock to focus on new lending, the company will be restructured so that the back book of mortgages is managed separately to its other business. The restructuring will be implemented subsequent to state aid approval from the European Commission.

An assessment of competition impacts of the state support for Northern Rock between February 2008 and February 2009 can be found in a report released by the OFT in March 2009.

The OFT considered two possible areas of concern arising from public support for Northern Rock. Firstly, that a public perception of Northern Rock as 'safer' than other banks could distort the personal current account, savings and investment product markets, and secondly that Northern Rock might be able to take advantage of a lower cost of capital to offer mortgages at lower prices and so increase its market share.

Taking into account the available information, including the constraints placed on Northern Rock by its 'competitive framework', and in the context of severe financial instability in the year to February 2009, the OFT concluded that public support for Northern Rock did not, during that period, have a significantly adverse impact on competition.

The European Commission state aid inquiry is ongoing.

9. Government as an influencer

Key points:

- Government is increasingly seeking to influence consumer behaviour and firm actions indirectly.
- Encouraging self-regulation can be an effective way of avoiding direct regulation, but it is important to be aware of the potential for encouraging anti-competitive coordination.
- Behavioural economics suggests that consumer behaviour plays a key role in determining the degree of competition in some markets. Government and regulators may have an important role in ensuring that consumers can play an active role in markets, for example through having the appropriate information and being able to switch supplier easily.

There is increasing interest in the indirect role that Government has in influencing markets. Government has a wide range of channels – for example, policy statements, information campaigns and discussions with key parties – through which it can affect the behaviour of businesses and consumers in markets, without necessarily requiring direct regulation or intervention.

Influencing consumers

Government may intervene in markets to change consumer behaviour where such behaviour has adverse effects on society or because of fears of adverse consequences for the individual consumer over the long-term. An example of such behaviour is excessive alcohol consumption which has been linked with antisocial behaviour and health risks and imposes significant costs to the police and the health care system.

Government can focus on the demand side by attempting to influence consumer behaviour in a variety of ways, for example, through regulation or the tax system. In the case of alcohol, products are taxed at a higher rate than other goods and consumers under the age of 18 are banned from consumption. Government can also use advertising campaigns and educational programmes to highlight the costs associated with this behaviour.

Behavioural economics is increasingly providing evidence that consumers do not always behave in a 'rational' way in the sense traditionally implied by economic models. This suggests that Government can play an important role in making markets function better by increasing consumers' participation and engagement in markets.

Box 9.1: Food Standards Agency salt campaign

Population average salt intakes in the UK are currently at 8.6g per day, considerably above the 6g intake target set for adults. Excessive salt consumption can increase the risk of having high blood pressure, which in turn increases the risk of heart disease and stroke.

The Government's work to reduce salt intakes is conducted by the Food Standards Agency and the Department of Health, the key aim of which is to reduce average population salt intakes to 6g a day for adults, and to meet the recommendations for children (who should have less). This policy objective is pursued through three main strands:

- a public campaign to raise consumers' awareness of why a high salt intake is bad for their health and what they can do to reduce intakes
- working with the food industry to reduce levels of salt in foods as around 75 per cent of the salt we eat is already in the every day foods that we buy, and
- front of pack labelling to provide additional information to consumers on the levels of salt (and other nutrients) in food.

The programme of work has been successful in reducing average daily intakes. There has been a decrease of 0.9g per day compared to levels measured in 2000/01 (when intakes were at 9.5g), and this reduction equates to the prevention of around 6,000 premature deaths every year and a saving of £1.5 billion to the economy.

Further details are available on the FSA website at:
www.food.gov.uk/healthiereating/salt

Influencing businesses

In relation to business behaviour, there may be cases where encouraging self-regulation by firms in an industry is seen as an alternative to direct regulation. For example, businesses can agree on certain quality standards by signing up to a code. This may produce important benefits for consumers.[31]

Self-regulatory and consumer approaches may work alongside formal regulation. For example, consumer preferences might be influenced through restrictions on advertising, similarly, statutory regulation might be used as a backstop if attempts at self-regulation by industry fail.

Government may also wish to intervene to coordinate private sector activities where information necessary for investment decisions is not available. Individual private firms typically make their investment decisions based on the information available in the market, and in some cases their returns will be linked to the investment decisions of other firms. Lack of information and uncertainty regarding others' investment decisions may mean that a firm may under- or over-invest and in some cases a firm may not invest at all. If no firms invest in, for example, large infrastructure projects or increased professional training, then the wider benefits to society are not realised.

31 For example, see OFT (2006a).

A recent example of Government coordinating private sector activity relates to electric vehicles. In order for car manufactures to be confident enough to produce electric vehicles they need to know that the infrastructure to power them will be in place as it will be essential for consumer demand. Similarly, in order to commit investment, producers of chargers need to know that electric vehicles will exist. Government co-ordination may be needed to facilitate development of this type of market.

There are, however, risks associated with coordinating private sector activity, particularly when this brings together a group of competing firms. Government coordination could inadvertently facilitate anti-competitive collusion or the creation of barriers to new firms wishing to enter the market. (This is particularly the case when standards are set with reference to intellectual property owned by a particular firm).

Key points for policy makers

The OFT has published recent discussion papers on self-regulation and environmental product standards, both of which give background to the pros and cons of different approaches to self-regulation and voluntary agreements.[32]

Where Government encourages agreements between businesses, to exchange information or agree minimum standards for example, it must be remembered that agreements between firms are covered by competition law. The fact that Government is encouraging an agreement does not affect whether it is permissible under competition law. In this respect, this raises a different set of policy considerations for Government compared with direct statutory regulation, which is typically not subject to competition law. The Department for Business, Innovation and Skills has published guidance for policy makers on situations where agreements between firms are being considered.[33]

The main costs of self-regulation can occur if agreements between firms materially reduce competition between them. For example, agreements between firms on prices (or even the exchange of pricing information) will typically lead to a significant reduction in competition between them. This is reflected in competition law by the fact that price-fixing is almost always deemed to be illegal.

In economic policy terms, the relevant question for policy makers is whether the benefits of self-regulation outweigh the costs. Benefits include, for example:

- Firms will typically have better information than Government on feasible quality standards or market outcomes. They may therefore be better placed to design regulation.
- Self-regulation can be more flexible than statutory regulation, making it quicker to implement, and easier to adjust if circumstances change.

32 OFT (2008c).
33 BERR (2008a).

10. Government as a market maker

Key points:

- Government can sometimes use markets to deliver policy objectives.
- Market mechanisms, if well designed, can bring benefits of consumer choice, and increased efficiency.
- Market mechanisms are generally less restrictive of competition than more traditional 'command and control' interventions.
- There is still a role for Government, but as designer and supervisor rather than regulator or provider.
- The market making role typically requires policy makers to be creative – it is not always obvious how and when market mechanisms might be used in place of more direct policy instruments.

The basic principle of the Government acting as a market maker is to introduce competitive pressure between buyers and sellers. The aim is to harness the power of markets to deliver wider policy objectives. Well-designed market processes can avoid the restrictions on competition of more traditional 'command and control' approaches.

A well-intended 'command and control' intervention could in some circumstances result in goods or services being provided at an inefficiently high cost or poor quality, as the Government does not typically have access to prices as a signal of consumers' preferences. A market mechanism, with the Government playing a role in market design, supervision, and enforcement, should provide the necessary incentives for goods or services to be provided efficiently while achieving the same policy goals.

There are at least three common mechanisms through which Government can intervene as a market maker:

- competitive tendering
- user choice, and
- tradable permits.[34]

The first two of these mechanisms are used primarily in the delivery of public services where, without Government intervention, markets will not deliver socially beneficial goods and services, such as education, health and defence. Traditionally these are areas where the public sector might have relied on direct provision through a monopoly.

Tradable permits, by contrast, are a way for Government to deal with negative externalities in private markets and are usually used in situations where private firms' production results in side-effects that adversely affect society, such as pollution and environmental damage. Rather than intervening directly through regulation or taxation, the policy aim of reducing the harm to society can be achieved by establishing a market for tradable permits, for example.

34 DTI (2005).

Public service delivery

Public monopolies providing public services face the same incentive problems as private ones: the lack of competition means that the pressure to increase efficiency or quality is low.

Competition can be introduced through competition for the market, where suppliers compete for a contract to deliver a good or service and the Government picks the one that provides the best value for money. Competition for the market is more suitable when there is a natural monopoly and/or consumers are unlikely to be effective in exercising choice. Competition for the market is considered in more detail in Chapter 11.

Competition can also be introduced through user choice. Rather than having a public monopoly providing a service, several public and private suppliers compete in a market where consumers are given the right to choose their preferred supplier. More popular providers gain users at the expense of the less popular ones, providing incentives for the suppliers to be more responsive to their customers' needs.[35] Choice in the market relies on 'active' consumers and also requires sufficient opportunity for rivalry between suppliers.

Tradable permits

Tradable permits introduce a market element into the regulation of private firms' activities. This type of additional intervention is a response to the fact that there may be very different costs for different firms associated with meeting the requirements of regulation. Conventional 'command and control' type regulation typically offers little flexibility in the means of achieving a particular goal, for example reduction in pollution. Firms are often forced to shoulder similar shares of the pollution-controlling burden, regardless of the relative costs to them. With this type of regulation there is little incentive for innovation, or for firms to exceed their targets.[36]

Introducing tradable permits can allow some flexibility and reward efficiency. This has two advantages compared to the 'control and command' system: it ensures that pollution is minimised in the most cost-effective way[37] and it provides strong incentives for innovation.[38] In the US, tradable permits are the most frequently used environmental instrument.[39] See the case study on EU Emissions Trading Scheme in Box 10.1.

Key points for policy makers

Market-based mechanisms will generally be pro-competitive. Letting customers choose their service provider signals which providers are the best, and provides incentives for others to improve. Market-based mechanisms are generally less prescriptive and there is less intervention than with detailed regulation of quality of services, and possibly less risk of adverse effects and unintended consequences.

However, market-based mechanisms may not deliver the policy outcome as expected. For example, allowing choice over what school children attend, by providing parents with vouchers for example, should create benefits in two ways: parents and students would opt for

35 Policy makers should take care to ensure that user choice competition provides benefits to everyone and not just the individuals who actively make a choice. If not, this could lead to increased inequality where not all consumers have access to the same information, which could have negative impacts.

36 Portney and Stavins (2000).

37 It would be possible for Government to achieve cost effectiveness through a 'command and control approach, but it would require access to very detailed information about all firms' costs and technology options for reducing pollution.

38 Portney and Stavins (2000).

39 Ibid.

schools that are better than the one they would normally be allocated to (the direct effect), and increased competition would encourage other schools to improve in an effort to attract students, so the students whose parents do not make a choice benefit as well (the indirect effect).

A recent review of US voucher pilots concluded that there was no conclusive evidence for the potential for user choice to improve public schools.[40] A possible reason is that users consider different indicators of quality – for example sport facilities or religious affiliation – that do not necessarily match the Government's objectives of improving the overall quality of education.

Box 10.1: The EU Emissions Trading Scheme

The Stern review of the Economics of Climate Change (2006) called climate change 'the greatest and widest-ranging market failure ever seen' and made it clear that urgent action was needed to reduce CO_2 emissions to avoid future harm. It also emphasised the need for a price driven instrument, common across countries, to reflect the damage CO_2 emissions were causing the environment, as well as to allow flexibility in how, when and where emissions reductions are made.

Through the EU Emissions Trading Scheme, Governments cap CO_2 emissions in certain sectors and allocate allowances to emit on a national level. Allowing firms to trade their allowances led to the establishment of a market for carbon emissions. More 'carbon efficient' firms can sell excess allowances to less efficient firms, while overall emissions reduce in line with the cap.

The establishment of a market provides an incentive for firms to invest in cost-effective CO_2 reducing technologies; the cost of an allowance will reflect the marginal cost of CO_2 reduction. In general, this type of intervention is not likely to cause significant distortions of competition. It encourages efficiency and innovation, and rather than distorting firms' incentives, the scheme ensures that CO_2 is seen as another input (like fuel) which the firm then seeks to minimise the cost of.

The development of the EU Emissions Trading Scheme also demonstrates some of the difficulties in designing market-based approaches. For example, there could be issues of increasing barriers to entry, and the scheme would have to be designed to allow adjustments in the cap to reflect the size of the market. There could be some concern over 'carbon leakage' and the competitiveness of firms in the scheme compared to firms outside. And there is ongoing discussion about how carbon permits should be allocated initially. Arguably an initial auction of permits could improve the efficiency of the market.

40 Rouse and Barrow (2008).

11. Public procurement[41]

Key points:

- Public procurement can be used to introduce competition for goods and services previously supplied solely by the public sector.
- Where Government is a major buyer in a market, its purchasing decisions can have significant effects on competition.
- Public procurers need to consider the wider market and longer-term effects of procurement decisions in order to maximise competition and secure best value for money.
- In some situations, Government can use its buyer power to encourage greater competition between suppliers.
- Government procurement can also play an important role in shaping markets for example through supporting new technologies or products.

The Government acts as a buyer from private firms for two main reasons:

- To provide a public good or service as a response to a market failure (see Externalities on page 12) such as health care, law and order, housing and community amenities, environmental protection etc.
- To support it in carrying out its functions, Government buys goods and services from private or third sector providers. Typical goods bought would include buildings, vehicles, computers and programmes; services would include IT and payroll services, consultancy, policy advice, research and catering and cleaning.

The figures involved in public procurement are substantial. On average, public procurement accounts for 20 per cent of OECD countries' GDP.[42] The 2008 Julius Review[43] found that in 2007/8 the UK public service industry[44] had a turnover of £79bn, generating £45bn in direct value added and employing over 1.2 million people. It also indicated that, over a 12 year period to 2007, the public service industry grew at an average annual rate of over 5 per cent in real terms.

Procurement is usually carried out through competitive bidding or tendering. This process should enable Government to identify the most efficient supplier, thereby ensuring the highest value for the tax payers' money. The Julius Review indicated that cost savings from competitive tendering were typically between 10 per cent and 30 per cent.

In some cases Government can also act in partnership with the private sector. For example, the Private Finance Initiative (PFI) has been used extensively in procuring physical assets (for example, schools and hospital buildings)

41 More detail on the competition impacts of public procurement can be found in OFT (2004), 'Assessing the impact of public sector procurement on competition'.

42 OECD (2007b), page 7.

43 BERR (2008b).

44 The term 'public service industry' refers to firms involved in providing public services on behalf of Government.

from the private sector. Partnership arrangements can be used to share risks with the private sector, and in some cases to give the public sector a degree of longer-term control over assets.

Buyer power

Public procurers can be said to have buyer power where their individual purchasing decisions influence the overall prices and products provided in a market. Like private sector buyer power, public sector buyer power may come from two main sources:

- buyer power may be related to the size of demand of the public sector relative to the total demand in a particular market, or
- a buyer may enjoy power because it is a strategically important customer for its suppliers.

Buyer power can be good for consumers because it can drive down prices and encourage suppliers to become more efficient.

There are three main channels through which procurement can affect competition: short-term effects, long-term effects and knock-on effects on other buyers.

Short-term effects

Short-term effects include effects on the intensity of competition amongst existing suppliers in a particular tender, taking the number of firms in the market, the range of products available and the underlying production technology as given.

A possible risk to value for money of Government procuring goods and services from the private sector comes from the potential for collusion, or bid rigging. This occurs when firms that would otherwise be expected to compete collude to raise the price or lower the quality of the goods or services bought by the Government.

Such behaviour is illegal under competition law. The OFT is currently investigating 112 English construction companies alleged to have been involved in bid rigging in a diverse range of projects, including tenders for schools, universities and hospitals. To foster competition, OECD guidelines for fighting bid rigging in procurement can help Government to design tenders to detect and hinder bid rigging during the tender process.[45]

Long-term effects

This includes long-term effects on investment, innovation and the competitiveness of the market, that is, effects that capture changes in market structure and technology caused by public procurement. This could be reflected, for example, in the level of competition in future tenders.

Where Government is able to use its buyer power, it may have opportunities to 'manage competition' among suppliers to shape the market structure in order to achieve long-term efficiency, by encouraging innovation and investment. Buyer power could be an effective control for entry of efficient firms and exit of inefficient ones and creation of new products.

45 OECD (2009).

Knock-on effects on other buyers

Where the public sector accounts for much, but not all, demand in a market, Government procurement decisions will have an impact on other buyers. For example, the public procurement decisions may have an effect on the number of suppliers, the technologies used, and the range of products available. Private sector buyers without the same level of buyer power may not be able to shape the market in this way.

Key points for policy makers

Policy makers should ensure that in markets where the Government potentially has buyer power, this buyer power is not exercised in a way which could distort competition or reduce the efficiency of markets.

Policy makers should also be careful when designing procurement mechanisms to consider the market conditions in which providers compete. In short, this involves considering whether a particular buying strategy:

- increases the intensity of effective competition between existing firms or products in the market (short-term effects)
- creates opportunities for increasing investment, innovation and the competitiveness of the market as a whole (the long-term effect)
- changes the market structure (competitiveness and technology) in a way that significantly reduces the opportunities faced by other buyers (knock-on effects).

Further, the tendering process should be carefully designed in order to minimise the risk of collusion and bid rigging among the potential competitors.

Frequently a major difficulty for Government is how to make best use of its potential buyer power. Public procurement can sometimes be relatively disaggregated across different local authorities or departments, for example. Moves to coordinate buying activities can, therefore, have a positive effect on competition.

When Government has buyer power, it needs to make sure that smaller providers or new entrants have the same opportunities as in-house, incumbents and big providers. Government also needs to consider that small buyers may be affected if, for example, Government procurement leads to a significant decrease in the overall output. This could alter the conditions that Government providers offer to Government competitors (other buyers).

More detail of the competition impacts of public procurement can be found in OFT (2004), 'Assessing the impact of public sector procurement on competition'.

Box 11.1: Waste procurement

The OFT worked closely with the Office of Government Commerce (OGC) and the Department for Environment, Food and Rural Affairs (Defra) to examine the effects of public procurement on competition and capacity in the municipal waste sector. The value of the sector is estimated to be approx £2bn. 'More Competition, Less Waste' was published by the OFT in 2006, making recommendations to central and local Government for encouraging more competition for municipal waste collection services.

There were concerns that, as the treatment sector grows, local authorities should avoid over dependency on a limited number of suppliers. The recommendations included:

- Local authorities should set contracts of a sufficient length to allow suppliers a reasonable return on their investment, but in general no longer than five years.
- Local authorities should avoid setting selection criteria that require suppliers to have previous experience in the municipal waste collection sector. This should encourage more bids.
- When including in-house providers in an invitation to tender, local authorities should take care to ensure competition on a level playing field so that private suppliers are not discouraged from bidding.

The OFT's recommendations for municipal waste treatment included:

- Local authorities should tender separately for municipal waste treatment contracts and landfill contracts. Priority should be given to finding mechanisms to deliver bids from a number of suppliers, both within and outside the region which will mitigate the risk of regional monopolies.
- Local authorities should guard against the risk of collusion. For example, information relating to waste management contracts in the pipeline may encourage bidding, but care needs to be taken to avoid giving suppliers the ability to collude and share out contracts.

12. Government as a supplier

Key points:

- There can be situations where direct provision of goods and services by Government is in the best interests of consumers.
- Where it is the direct provider, Government needs to be aware of the costs of crowding out private sector activity.
- Similarly, Government should ensure that public bodies that compete alongside private firms do not distort the market unfairly.
- In some cases Government can open up new markets by freeing up access to monopoly services – for example by making it easier for private firms to access public sector information.

In the past, the public sector has been a direct provider of many goods and services. Over time, this role has reduced for several reasons:

- the privatisation of previously state-owned enterprises, for example energy, water and telecoms companies, and subsequent economic regulation of these activities
- the introduction of competitive tendering for many public services, as described in Chapter 11
- the growing use of public-private partnerships as an alternative to direct state provision.

Nevertheless, Government still plays a role as a provider in some markets. Government may choose to act as a supplier of goods and services for social or ethical reasons. For example, in the UK the NHS ensures that all citizens have access to health care.

In some cases, assets owned by Government for social, environmental or security reasons have commercial value, which can be used to provide goods and services to consumers. For example, the Land Registry collects information on house purchases, and provides some of this information to consumers and intermediaries.

Government has also taken on a greater ownership stake in some businesses in recent months as a result of the economic downturn, notably the UK banks.

Key points for policy makers

Where Government is the only provider of a good or service, there may be opportunities to secure efficiencies through greater use of competition. Two options involve competitive tendering of services (as set out in Chapter 11) or making use of consumer choice in determining how spending is allocated within the public sector (as described in Chapter 10).

Even in markets that were initially considered as natural monopolies, competition has been effectively used to achieve significant cost savings, improve quality, foster innovation and to develop new products for consumers. Through statutory monopoly schemes, Government provides the essential facilities and allows private firms to compete for the operation of these markets within a regulatory framework. This has been applied in sectors such as the postal service, broadcasting, transport and utilities.

In some cases, Government may also be able to generate greater economic benefits by allowing third party access to public sector assets. For example, the OFT's market study on commercial use of public sector information suggested that greater access to public sector data by commercial firms could generate benefits of at least £500m per year.

Where public sector bodies are engaged in mixed markets alongside private firms, it is important for the public bodies to ensure that they are not exploiting unfair advantages over the private sector and stifling innovation or improved efficiency that private firms may bring to the market.

Box 12.1: Commercial use of public sector information

Many public bodies hold valuable information assets. For example, Met Office weather data, Ordnance Survey mapping data, and Land Registry information all have significant potential in commercial applications.

In many cases where private firms can add value to public sector information, such as in-car navigation systems, the public sector information holder is the monopoly provider (typically because of high fixed costs of collection, or statutory collection powers). In some cases the public sector body may also be competing with private firms in the downstream market for value added products.

In its 2006 market study,[46] OFT concluded that access to unrefined public sector information needed to improve, and estimated that the potential benefits of increased competition could include a doubling of the value added to the UK economy, contributing around £1bn per annum.

Subsequent Government reviews, including the Trading Funds Assessment, have set out principles of improving access to public sector information. These principles are:[47]

- information easily available – where possible at low or marginal cost
- clear and transparent pricing structures for the information, with different parts of the business accounted for separately
- simple and transparent licences to facilitate the re-use of information for purposes other than that for which it was originally created, and
- clearly and independently defined – with input from customers and stakeholders – core purposes ('public tasks') of the organisations.

46 OFT (2006c).

47 HMT (2009b), page 41.

Annexe A
A brief guide to competition and consumer law

Certain legal restrictions apply to firms and public bodes operating in markets. This section outlines the most important ones, but this should not be taken as comprehensive or definitive guidance. Detailed guidance can be found on the OFT website.[48]

Competition Law

Competition Act 1998[49]

In the United Kingdom, the Competition Act 1998 was introduced to ensure that businesses compete on a level footing. It does so by prohibiting certain types of anti-competitive behaviour (the Chapter I and Chapter II prohibitions). Together with EC legislation, the act prevents two main categories of anti-competitive behaviour:

- anti-competitive agreements (for example, cartels and collusion) between businesses are prohibited by Chapter I of the Competition Act 1998 (CA98) and Article 81 of the EC Treaty
- abuse of a dominant position in a market is prohibited by Chapter II of CA98 and Article 82 of the EC Treaty.

The laws contained in the CA98 and Articles 81 and 82 of the EC Treaty are similar but not the same. The CA98 prohibits certain anti-competitive behaviour (agreements that prevent, restrict, or distort competition and abuse of a dominant position, respectively) that affects trade in the UK. Articles 81 and 82 prohibit certain anti-competitive behaviour (agreements that prevent, restrict, or distort competition and abuse of a dominant position, respectively) that affects trade between EU member states.

Exemption from Article 81 and Chapter 1 can be granted through the application of the 81(3) of the EC Treaty exemption clause (and the very similar exemption under section 9 CA 98) for an agreement which:

'… contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:
(a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;
(b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.'

Merger control[50]

The definition of a relevant merger situation in the Enterprise Act 2002 covers several different kinds of transaction and arrangement. A company that buys or intends to buy a majority shareholding or a significant minority shareholding in another company is the most obvious example, but the transfer or pooling of

48 www.oft.gov.uk

49 Further information on Competition Act 1998 can be found at www.oft.gov.uk/advice_and_resources/publications/guidance/competition-act and http://ec.europa.eu/competition/antitrust/overview_en.html

50 Further information on merger control can be found at www.oft.gov.uk/shared_oft/mergers_ea02/oft527.pdf

assets or the creation of a joint venture may also give rise to merger situations. The Act's provisions apply both to mergers that have already taken place (subject to time limits) and to those that are proposed or in contemplation. All else being equal, a merger of two firms will result in fewer firms competing in a market, which could have detrimental effects on competition and consumers.

Under the Enterprise Act 2002, the OFT has a function to obtain and review information relating to all anticipated and completed merger situations, and a duty to refer to the Competition Commission for further investigation any relevant merger situation where it believes that it is or may be the case that the merger has resulted or may be expected to result in a substantial lessening of competition in a UK market. Mergers with an EU-wide dimension are covered by the European Commission under the EC merger regulation.[51]

Market investigation references

In addition to enforcing the two prohibitions in the Competition Act and Article 81 and 82, the OFT may refer a market to the Competition Commission for further investigation if (applying the test in section 131 Enterprise Act 2002) it has reasonable grounds to suspect that one or more features of a market in the UK prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK (or a part of the UK). Following any reference, the Competition Commission will investigate the market or markets concerned and publish a report setting out its view as to whether there is an adverse effect on competition. If it finds an adverse effect, it must consider and put in place remedies to address it. The remedies can be by way of an order. The order can require businesses to change their practices. In appropriate cases it can also require divestment of parts of a business.

Consumer Law

Consumer protection laws aim to ensure that consumers are not disadvantaged by businesses that do not comply with their legal responsibilities by providing consumers with information and protection, and establishing their rights in relation to traders they deal with. The following paragraphs highlight some of the main consumer protection laws, but this is not intended to be comprehensive.

Unfair Terms in Consumer Contracts Regulations 1999

These Regulations protect consumers against the use of unfair standard terms in contracts they make with traders. The OFT, and certain other bodies, can take legal action to prevent the use of such terms.

All business suppliers using standard contract terms with consumers must comply with these Regulations. A standard term is unfair 'if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer'. Unfair terms are not binding on the consumer.[52]

The OFT produces general guidance on unfair contract terms as well as industry specific guidance.

Consumer Credit Act 1974

This Act establishes a regime for the protection of consumers in credit and related transactions and a licensing system for traders concerned with the provision of credit or the supply of

51 Regulation 139/2004/EC.

52 www.oft.gov.uk/shared_oft/reports/unfair_contract_terms/oft311.pdf

goods on hire or hire purchase or providing ancillary credit services. The OFT administers the licensing system, granting, refusing and revoking such licences. Trading without a licence is a criminal offence and can result in a fine and/or imprisonment. The Act also contains detailed information requirements and regulates the enforcement and enforceability of certain credit and hire agreements. The OFT has recently been given enhanced powers in relation to licensing under the Consumer Credit Act 2006.

Consumer Protection from Unfair Trading Regulations 2008

The Regulations introduce a general duty not to trade unfairly and seek to ensure that traders act honestly and fairly towards their customers. They set out broad rules outlining when commercial practices are unfair. These fall into four main categories:

- a general ban on unfair commercial practices
- a prohibition of misleading practices, like false or deceptive advertising, or leaving out important information
- a prohibition of aggressive practices that use harassment, coercion or undue influence
- in addition, the regulations ban 31 specific practices in all circumstances.

For a practice to be unfair under these rules, it must not be professionally diligent and it must materially distort, or be likely to materially distort, the economic behaviour of the average consumer. For example, when a shopper makes a purchasing decision he or she would not have made had he or she been given accurate information or not put under unfair pressure to do so.[53]

53 www.oft.gov.uk/shared_oft/business_leaflets/cpregs/oft979.pdf

Annexe B
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