LI-Paper

Why the Best Form of Regulation is Competition

ANTHONY EVANS * • November 2018

Summary

- Regulation is necessary and important. The question is, however, who can perform this task best and most efficiently.
- Government regulations typically cause new problems, such as unforeseen consequences and side-effects, which in turn make new regulations necessary. Government regulations also arouse a deceptive sense of security and let one's own responsibility erode. Also, overregulation leads to the emergence of black markets, where products of questionable quality are offered. Excessive quality standards may drive up prices for consumers unnecessarily.
- An alternative to state intervention is regulation through market mechanisms. For example, the reputation of a company or a brand limits the scope for fraud. Even in the case of asymmetric information between customers and companies, there is an entire industry on the open market that offers solutions: e.g., private certification bodies, guarantees and free trials.
- Even extreme situations such as exploitation of workers can be tackled in a competitive market. Freedom of contract ensures that people only sign contracts that they consider beneficial and can get out of those contracts that no longer meet their expectations.
- Regulators have traditionally followed the textbook theory by defining competition as the degree of market concentration. Rather, a competitive market would have to be judged by whether it is free for new entrants. Because governments tend to be the ones to blame for these obstacles, their main task is to reduce such access barriers.

* The author is Professor of Economics at ESCP Europe Business School in London. He is part of the MOC Affiliate Faculty for the Institute for Strategy and Competitiveness at Harvard Business School, and is a member of the Institute of Economic Affairs' Shadow Monetary Policy Committee. This paper was presented at the Liberal Institute's Better Regulation Conference on 25 September 2018 in Geneva.

We need regulation, but the common way in which regulation is applied can backfire. I believe that a major problem with how we engage in regulation is an insufficient appreciation for how markets – even those which are not perfectly competitive – function.

In this article I want to cover three main points. Firstly, the relationship between regulators and the market. Secondly, what sort of consumer protection is necessary. And thirdly, which institutional mechanisms are best at improving the flow of knowledge. The bottom line is that a genuinely competitive market process is the best way of regulating industry, and we should encourage regulators to uphold such a market.

The relationship between regulator and the market

The trend in banking regulation (even prior to the latest financial crisis of 2008) has been that banks try to find loopholes in new legislation, and this prompts further revisions. The result of this cycle is ever greater complexity. This is a problem because it means that we do not know how regulations will be gamed, but we do know that if firms adopt similar strategies this will increase systemic risk.

The Financial Times journalist Tim Harford has used the example of the VW emissions scandal.[1] The regulator had predictable tests and firms' behaviour was focused on trying to pass those tests, losing sight of the underlying problem that testing was supposed to solve. Harford suggests that a better method is "randomly times tests of arbitrarily chosen areas" – in other words, an exam. If students don't know what will be on the test, the optimal strategy is to revise everything and cover all bases.

In his 2012 Jackson Hole speech, Andy Haldane (now Chief Economist at the Bank of England) argued that regulators should focus on heuristics (i.e. rules of thumb) rather than complex regulatory mechanisms.[2] He said, "you do not fight fire with fire, you do not fight complexity with complexity". We need to break out of that cycle, but using exams as the underlying metaphor is wrong.

In an exam the instructor will have knowledge of the content, and the student is tested against that. In the case of a dispute, the instructor is "right". When applied to the banking system this implies that the regulatory agencies have knowledge of the risks, and banks are trying to circumvent them. But in a dispute, how do we know who is right? It should not be treated as a game between an omniscient presence and a nefarious subordinate. And to the extent that regulation is focused on consumer protection, it is not actually necessary.

[1] Harford, T., (2016) Messy, Riverhead.
[2] See Haldane, A., (2012) "The Dog and the Frisbee" Federal Reserve Bank of Kansas City's 366th economic policy symposium.

What sort of consumer protection is necessary?

There is a wide rationale for consumer protection, but it is important to recognise the ways in which a competitive market process – grounded in the rule of law – can provide this. For example, consumers demand protection from fraud or extortion. But reputational mechanisms (such as customer testimonials or branding) place restrictions on what companies can get away with. In addition, we have the courts to protect customers from the threat of physical force. Indeed, it is important to emphasise that the legal system rests on the protection of private property rights, and regulatory agencies that have the authority to confiscate or compulsorily reallocate resources actually undermine this.

A common reason for consumer protection is the fact that the general public do not have perfect information, and their state of ignorance may be exploited. However, a whole industry of solutions exists to mitigate these information asymmetries, through things such as third-party certification, warranties, and free trials or samples. Market imperfection is an inefficiency, and any inefficiency is a profit opportunity.

Even extreme situations such as worker exploitation can be pursued through a competitive market, where the freedom of contract ensures that people only enter contracts they deem beneficial.

Not only is competition able to address some of these concerns, it does so without introducing new problems that are associated with regulation. These include:

- *The dynamic of intervention.* Once one regulation is adopted there can be a call for additional ones to correct unforeseen issues. For example, excessive safety standards may lead to a false sense of security and to an increase in accidents due to additional risk-taking. This leads to demands for further safety regulations, which result in even more accidents (for the same reasons). The end result is an arms race of safety standards and a cycle of complexity.
- *Rent-seeking.* The recent Congressional hearings on Facebook made it clear that legislators had no understanding of a social media company's underlying business model. Although they claimed that they were in the public interest, and protecting consumers against invasions to their data privacy, it is in fact the government that does most to threaten privacy. Rather, the main purpose of the hearings was to find an angle to extract rents from a profitable company. Governments do not protect the public from extortion; extortion is precisely what they do – through taxation and excessive regulation!
- *Excessive quality standards.* When regulator invoke minimum quality standards these tend to popular, because few people want quality to be low. However, it is possible to have unnecessary high quality. Excessive minimum standards may lead to shortages and overpriced products, for example in the housing sector.
- *Unintended consequences.* Excessive regulation may lead to the formation of black markets, to increased costs of living harming low-income households, and encourage unregulated alternatives that are less safe. By limiting supply,

driving up costs, and restricting competition and choice, regulations end up reducing quality and hurting the consumers they allege to protect.

Which institutional mechanisms do improve the flow of knowledge?

Instead of viewing regulation as a game between the regulators and the banks, the focus should be on the knowledge flows between the banks and the market as a whole. This occurs in a situation where:

- we do not know who will encounter relevant information,
- we do not know what information is pertinent,
- we do not know what behaviour is consistent with the desired risk profile of customers.

Consequently, there are two options. The first option is central planning. This is a hierarchical system where knowledge is supposed to flow up to the decision makers. Unfortunately, this introduces moral hazard because losses are collectivised. The second option is a decentralised system, i.e. a market. In markets decision rights flow down to whoever has the information, and the profit-and-loss system is used to guide behaviour. In concrete terms this means that excessive risk-taking (as judged by the market, not the bureaucrats) is penalised through bankruptcy, investors are rewarded for their attention to long-term profitability, and firms are free to experiment with different business models, which introduces choice for consumers, and thus reduces systemic risk.

Competitive markets are fast – in 2007 Mattel recalled several Chinese-made toys. Before regulators had even decided what sort of action might be appropriate, $2.75 billion had been wiped from the market value. The market was very quick to penalise the company.

Although most forms of regulation can be performed by a competitive market process, it is important to make two caveats. The first is to clarify exactly what is meant by a "competitive" market. The second is to establish the appropriate jurisdiction of the regulatory authority.

Regulatory authorities traditionally followed textbook theory by defining competition as the degree of market concentration. In this view the more concentrated a market is, the less competitive it is, and the greater the rationale for intervention. However, an alternative view is to define a competitive market purely on whether it is contestable – in other words whether new entrants face arbitrary hurdles. Since these hurdles tend to be enforced by governments their main role is to reduce these entry barriers. From a competition perspective such barriers harm consumers because they block profitable ventures. By contrast costs of entry reflect real resource scarcity and determine whether a venture is profitable in the first place. Costs of entry such as economies of scale, network effects and brand loyalty are not indicators of an anti-competitive situation. Indeed, if a monopoly is based on superior efficiency (i.e. it

operates at lower average costs than any potential rival) then this tends to be beneficial to consumers. And even if one argues that the monopoly in question impinges consumers, they do not tend to last over time. Competition authorities are always fretting about the perceived market dominance of particular large companies, but it is telling that the particular company in question changes over time.[3]

The second key caveat concerns the appropriate jurisdiction of the regulatory authority. There are some situations, such as the presence of externalities, that make it prohibitively costly to resolve them using market mechanisms. In which case some form of regulatory authority would be necessary. However, these may not coincide with the jurisdiction of a national regulatory authority. For example, instances of noise pollution on a university campus are best regulated through the local housing association. Instances of carbon dioxide emissions may be best regulated at an international level.

This article has not intended to be "anti-regulation". On the contrary, regulation is critical. However, I am making the case that the best form of most regulation is through competition and the market process, rather than the state. Ultimately regulation is too important to be left to the government.

[3] A tweet by Jerry Neumann makes this point well: In the 1960s, without government intervention no one would ever beat General Motors, in the 1970s IBM, in the 1980s Microsoft, in the 1990s GE, in the 2000s Walmart, in the 2010s Amazon. [https://twitter.com/ganeumann/status/1038528256436260869]

LIBERALES INSTITUT

Imprint

Liberal Institute
Rennweg 42
8001 Zürich, Schweiz
Tel.: +41 (0)44 364 16 66
Fax: +41 (0)44 364 16 69
libinst@libinst.ch

All publications of the Liberal Institute can be found at www.libinst.ch.

Disclaimer

The Liberal Institute does not represent institute positions. All publications and statements of the institute are contributions to education and discussion. They reflect the opinions of the authors and do not necessarily reflect the views of the Foundation Board, the Academic Advisory Board or the Institute's management.

The publication may be cited with reference to the source.
Copyright 2018, Liberal Institute