

Convergence Review – framing paper submission

This paper is a submission to the Convergence Review established by the Minister for Broadband, Communications and the Digital Economy Senator Conroy.

This submission focuses on questions of language as they pertain to the Review. As such it is made by DigEcon Research by way of assistance not as a particular point of advocacy. ¹

The Review

The Convergence Review is one of the first wide ranging policy reviews to be conducted since the current policy and economic orthodoxy of competition policy and neo-liberal orthodoxy were adopted in the 1980s.

Since then the reliance on markets and competition as a goal has been at the heart of policy discussions. The “framing paper” published by the Convergence Review is a typical example of how public policy discussions have been framed since².

The framing paper seeks “public submissions on what stakeholders see as the principles that should underpin any new policy framework and the issues these principles raise.” The proposed principles are imbued with the language of competition.

In discussing Principle 1 (arguing for a diversity of voices) it is said that “diversity that provides greater potential for competitive tension and innovation.”

Principle 2 extends this to an actual goal, saying, “The communications and media market should be innovative and competitive, while still ensuring outcomes in the interest of the Australian public.” It is justified as follows;

This proposed principle is also drawn from paragraph 5(a) of the Terms of Reference and is reflected in existing objects in the BSA and the Telecommunications Act. More broadly, the encouragement of competition is accepted as a key aim in most of the significant public policy reforms of the last two decades. A highly competitive media market is one that strives to meet the diverse needs of audiences and consumers by offering efficient services characterised by a need to continually innovate to compete effectively.

The paper is correct in noting the role that the “encouragement of competition” has played. Before a review as significant as the Convergence Review continues it is worthwhile reviewing the acceptance.

This submission focuses only on this over-arching principle that is accepted by the Review as a statement of fact, rather than being the subject of inquiry as part of the policy objectives.³

This submission really constitutes four separate papers that have been drafted to discuss four separate concepts that are used in policy discussion; competition, markets, efficiency and (relatively recently) regulatory forbearance.

Significance of language

The framing paper outlines a series of principles that variously include competition and diversity amongst the goals, as well as specific social goals such as content that “reflects and contributes to the development of national and cultural identity” (Principle 3).

The unhappy relationship between the competition goal and social policy is measured in Principle 2 as noted above where competition is qualified by ensuring outcomes in the public interest.

To some it appears that there is a distinction between Australian telecommunications policy (with objects of competition and universal service) and broadcasting policy (with objects of preserving the quality of Australian broadcasting and ensuring Australian content).

However, both are cases of delivering the fine balance between the benefits to be obtained from competitive markets against the need to ensure accessibility of services (to a telephone or relevant content).

The issue is compounded when the latter issue is described as being a kind of “market failure”, when instead it is a market consequence. This reflects that the key words in the policy discussion have been hollowed out of all meaning by continual repetition without analysis.

The attached papers deal with four of these words. The papers are offered to the Convergence Review in the hope that the Review will be very precise in its use of the words, and ideally be explicit in providing meaning to the words when used.

The words and a brief discussion of their relevance are;

Efficiency – used in public policy to mean “economic efficiency” whereas the general public use is only that part known as technical efficiency. The word is misleading in that sense. It is further misleading because it masks the fact that economic efficiency is by definition anti-equality.

Markets – used in public policy as a singular good, and only when they “fail” should Government regulate. Markets are actually all social constructions, and all deviate from the “market” of theory. Government’s role is the design of markets to achieve their benefits. The major benefit of a market is its contribution to information flow, not price outcomes.

Competition – used in public policy to describe rivalry between firms, whereas the theoretical benefits only accrue through rivalry for customers.

Regulatory forbearance – this term has recently been used in Australia and New Zealand to mean “no regulation”. The term is better reserved for its initial meaning which is the ability of a well-empowered regulator to forgo direct action on the basis that the desired outcomes are already being achieved.

The far wider concept of “regulation” which brings these elements together has not been able to be completed in time.

Summary

The Convergence Review has the opportunity to establish a policy framework of great significance to the economic and social well-being of Australians. Communications services are at the heart of the Digital Economy, by which we mean an economy transformed by the General Purpose Technology of ICTs.

As such communications policy has a significance similar to that of energy policy or monetary policy in establishing the future for the country. Such a task requires great clarity in the use of language.

¹ Prepared by David Havyatt, 10 June 2011.

² The Convergence Review refers to an independent review “to examine the policy and regulatory frameworks that apply to the converged media and communications landscape in Australia” see http://www.dbcde.gov.au/digital_economy/convergence_review

³ The author of the paper, David Havyatt, has separately had the opportunity to contribute to the submission by Communications Alliance on the specific principles and they will not be discussed here.

On efficiency

*This short paper discusses the use of the word “efficiency” in the context of policy discussions. It is not a fully referenced document and is intended to inform policy discussions.*¹

Context

In the course of a discussion of what principles and objects should underline the Convergence Review², one participant noted that he hadn't yet heard a reference to efficiency.³ A short discussion then ensued about the meaning of efficiency, and the initial commentator simply said “but we all know what efficient is.”

This paper addresses that question and highlights the fact that the word “efficient” in a policy sense has the meaning given to it by orthodox economics. The paper goes on to explain this definition relative to other definitions of efficiency. It concludes with consideration of why efficiency should not be accorded the pre-eminent position given to it in public policy.

“Efficiency” as used in public policy

The word “efficiency” is used in a public policy context to describe a specific economic goal. The word is used in the *Competition and Consumer Act 2010* as part of the objects of the Part IIIA access regime (s44AA reads in part “to promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets”) and in the definition of the Long-Term Interests of End Users in Part XIC (s152AB states that one limb of the LTIE test is “the objective of encouraging the economically efficient use of, and the economically efficient investment in[infrastructure]”).⁴

The Australian Competition and Consumer Commission (ACCC) has explained in the context of access declaration decisions under Part XIC its interpretation of the objective of efficiency.⁵

In the Commission's view, the phrase ‘economically efficient use of, and economically efficient investment in, ... infrastructure’ refers to the economic concept of efficiency. The concept of ‘efficiency’ consists of three components.

Productive efficiency. This is achieved where individual firms produce the goods and services that they offer to consumers at least cost.

Allocative efficiency. This is achieved where the prices of resources reflect their underlying costs so that resources are then allocated to their highest valued uses (i.e. those that provide the greatest benefit relative to costs).

Dynamic efficiency. This reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and in productive opportunities.

The first two of these concepts are familiar to new economic students. They are described by first introducing a concept called a “production-possibility frontier” which is the boundary of all the different quantities of outputs that could be produced using all the available inputs. It is conventionally demonstrated as a simple curve of all the possible combinations of two products (often guns and butter) that could be produced using all the resources available in the economy.⁶

The concept of “productive efficiency” is then easily defined as a combination of outputs that represents a point on the frontier. Any point closer to the origin represents a point where more of at least one good could be produced, a point further away from the origin is impossible.

“Allocative efficiency” is used to refer to the way of choosing the point on the curve that represents society’s choice. For this a concept called Pareto efficiency is introduced.

A combination of outputs is Pareto efficient if no-one could be made better off with a different choice of production without making someone worse off. This standard seems fine until you realise that the way it is translated is through the price system.

A consequence of that is that those who have the most resources (money) get to have a disproportionate say in what gets produced (in an allocatively efficient market).

The position becomes worse when you realise that in determining whether one outcome is more efficient than another the analysis tool adds the “Kaldor-Hicks criterion”. This states that one state is to be preferred if “no one could be made better off with no one being made worse off, or being bribed (or compensated) for being worse off”. This is the standard used in the technique known as Cost-Benefit Analysis.

In the real world, however, the bribe or compensation rarely occurs. Doing so is seen as an unjustified transfer.⁷

Let’s look at a really simple model of an economy. We have two goods that can be produced, which we will call necessities and luxuries. For convenience we assume that no one can consume more than one of either product, and that the economy can produce a total of two thousand and that luxuries and necessities each require the same resource.

For convenience we will assume a population of two thousand people, of whom one thousand are rich (have ten currency units) and one thousand are poor (have exactly one currency unit). All are prepared and can afford to pay one currency unit for a necessity, but the rich will pay up to nine currency units for a luxury.

Any combination that produces a total of two thousand demonstrates productive efficiency. But producing one thousand necessities and one thousand luxuries is what the theory says is allocative efficiency.

In real world policy discussions the concept of allocative and productive efficiency get criticised for being only “static” measures. The concept of “dynamic” efficiency is not as well understood. The term itself only tells us that something is changing over time.

An example of a policy consideration of “dynamic efficiency” is provided by Srzich.⁸ He provides a formal definition of dynamic efficiency;

The dynamic efficiency is the expected, present value of current and future total market surplus within a given time period, conditional on the timing of the incumbent making an irreversible investment at a point during the period under investigation. (P.51)

In his analysis he goes on to state;

The aim of regulation is to maximise dynamic efficiency by choosing a suitable policy recognising that prices and the timing of the firm’s investment may depend on this policy. (P.52)

His evidence, however, that this is the aim of policy seems to be his own projection;

Although not specifically expressed in these terms, an interpretation of the intended purpose of the new regulations was to enhance dynamic efficiency. The government

compared the performance of the New Zealand telecommunications sector and regulatory policies with those of other OECD countries and came to the view that New Zealand's performance would be enhanced by following the regulatory policy adopted by other OECD countries. The government stated that the policies were to ensure that the telecommunications sector becomes more competitive, with particular emphasis that the availability and quality of broadband services was a key enabler of economic growth. (P.100)

This discussion of dynamic efficiency misses the subtlety of the static efficiency concepts. The decision that is modelled is exclusively one of the timing of an investment and the maximisation of welfare. An alternative is the consideration of what investment to make, and indeed by whom. These would be the dynamic equivalents of the productive and allocative static concepts (the best time for the investment versus the best investment).

The concept of dynamic efficiency advanced by Srzich also implies an environment in which the "incumbent" firm is freely able to choose when to make the investment. That, however, is a luxury that only a firm that doesn't face competitors is able to make. To create that kind of dynamic efficiency we therefore are expected to give the firm the market power that forecloses the dynamic efficiency afforded by alternative investors.⁹

Relation to other meanings of efficiency

The theories of eliminating monopolies and of free trade are both based on the benefits of allocative effects, not the benefits of increased production. Leibenstein outlined a number of studies that demonstrated that the concept of allocative efficiency much loved by policy theorists has an almost negligible effect on output.¹⁰

He introduced instead a concept he called X-efficiency, which related more to managerial efficiency within firms rather than distributive efficiency in the economy.

Farrell addressed the problem of measuring productive efficiency.¹¹ He identified two components of the productive efficiency of a firm. The first was "technical efficiency", this measures the success of a firm in producing the maximum output with a given proportion of inputs. The second was "price efficiency" by which was meant the success of the firm in choosing an optimal mix of inputs.

There is some relationship between this price efficiency and allocative efficiency as properly understood. The classical treatment of allocative efficiency refers to the choice of mix of outputs of the economy, whereas the definition advanced by the ACCC refers to the mix of inputs, just as "price efficiency" does.

The accepted public understanding of efficiency is merely about doing more for less. We talk of fuel efficiency of a car as the number of litres per 100 kilometres, water efficient shower heads let you have a shower using less water, the energy efficiency of a fridge or television (the star ratings) refers to how many kilowatt hours of energy is consumed to keep your food cool or yourself entertained.

But this kind of efficiency is only what the economists call "productive efficiency".

In management literature a distinction is made between efficiency and effectiveness.¹² Effectiveness means "doing the right things" while efficiency means "doing things right". The latter concept is what we would understand as productive efficiency while the former is what the economists call allocative efficiency.

In the managerial context we think at least we know what the "right things" are, or can determine them, against an objective criterion.

A current example from the telco policy space of how the economic definition of efficiency deviates from the ordinary language definition can be seen in the consideration of spectrum policy. A relatively large block of spectrum with good propagation characteristics is being made available through the conversion to digital television.

Emergency services organisations have expressed an interest in building a new radio network in this frequency, but it would require a large infrastructure investment and would be under-loaded. They will not rely on commercial networks as they can't secure guarantees of access in times of high demand.

The technology that will be deployed (LTE) by commercial operators will support service prioritisation which could give priority to the entire network resource to emergency services. The technically efficient outcome is for emergency services to be a commercial client with committed priority.

But the economic theory is that allocative efficiency will be derived from an auction of the spectrum.

Conclusion

The concept of efficiency is invoked repeatedly to justify policy decisions. The definition used is one that relies more on the allocative than the productive effect, but the term is almost universally understood by the public and even businesses to refer exclusively to productive efficiency.

The criterion used by orthodox economists is not based on equity, but is actively anti-equity. The preference of people with more money counts more in the calculus of determining what is "efficient". The results of the studies based on it are also often wilfully misrepresented – eagerly quoting how much the "average" Australian has benefitted from a policy reform, trying to create the impression that EVERY Australian has benefitted.¹³

A consequence of the myopic anti-equity focus of policies based on efficiency, which becomes competition and markets, is that it creates an automatic tension between competition and universal access. A working market may result in some consumers being denied the ability to acquire the things they want (or need) to, as in the simplified example. This is not a market failure but the market working.

Not only is the term "efficient" not well understood, the context in which it is used in policy is actually misleading as it mostly refers to allocative outcomes but appeals to the public's understanding of the term in its productive meaning.

This masks the fact that there can be a conflict between the definitions of efficiency. Recently the man who mows my lawn advised me that he would no longer be doing so, but introduced me to another mower. It was explained that the two of them had realised their territories overlapped and they were each visiting some streets to mow lawns. By doing a customer swap so only one of them went to a street they reduced travel time and increased technical efficiency. But it also reduced competition.

The way the policy debate often runs is large firms argue the benefits of allocative efficiency to deregulate markets, then argue productive efficiency to justify firm consolidation, with an appeal to dynamic efficiency as the saving grace for ongoing concentration.

"Efficiency" is not only open to interpretation, it is wilfully misused in policy discussions.

¹ Paper prepared by David Havyatt. This is the fourth version of the paper (following minor additions on dynamic efficiency and added detail to a footnote) and was published on 7 June 2011.

² The Convergence Review refers to an independent review “to examine the policy and regulatory frameworks that apply to the converged media and communications landscape in Australia” see http://www.dbcde.gov.au/digital_economy/convergence_review

³ This discussion occurred at the Network Insight Institute seminar “Internet, Telecoms and Convergence: the legal and policy challenge” held on 9 May 2011 see http://www.networkinsight.org/events/9_may_2011.html/group/7

⁴ S44AA was inserted following the review of the Part IIIA access regime by the Productivity Commission. (http://www.pc.gov.au/data/assets/pdf_file/0020/18173/access.pdf) It should be noted that AAPT Limited in a submission for which the author of this paper was responsible was one of the parties advocating the need for an objectives clause in Part IIIA.

⁵ ACCC *Telecommunications services — declaration provisions — a guide to the declaration provisions of Part XIC of the Trade Practices Act Dec 1999* P.55 (see <http://www.accc.gov.au/content/index.phtml/itemId/324247>)

⁶ The Wikipedia entry is quite useful. http://en.wikipedia.org/wiki/Production-possibility_frontier

⁷ That the condition of Pareto optimality is accepted in modern capitalist democracies is extraordinary given that Pareto himself was anti-democratic instead believing not only that elites do run society, but that they should run society.

⁸ Antony Srzich ‘The Effect of Technological Change and Regulation on the Evolution of the New Zealand Telecommunications Market’ A thesis submitted to the Victoria University of Wellington in fulfilment of the requirements for the degree of Doctor of Philosophy in Economics Victoria University of Wellington 2010 available at <http://researcharchive.vuw.ac.nz/bitstream/handle/10063/1467/thesis.pdf?sequence=2>

⁹ This is not the place for this discussion, but this opens up the whole area known as the innovator’s dilemma, and how industry change occurs because incumbents don’t invest in new technology and entrants do.

¹⁰ Harvey Leibenstein ‘Allocative Efficiency vs. “X-Efficiency”’ *American Economic Review* Vol 56 No 3 pp 392-415 Jun 1966.

¹¹ M. J. Farrell ‘The Measurement of Productive Efficiency’ *Journal of the Royal Statistical Society* Vol 120 No 3 Pp 253-290 (1957).

¹² See for example

http://www.businessandeconomics.mq.edu.au/undergraduate_degrees/undergraduate_units/ug_units/units/BBA_units/bba313_marketing_management_effectiveness_and_efficiency

¹³ As an example of this see the BCA release ‘BCA Calls for Reinvigorated Competition Policy Reforms to Boost Productivity’ at <http://www.bca.com.au/Content/99271.aspx> which estimates “National Competition Policy helped to increase the average wealth of Australians by \$83,000”. A worse example of the craft appeared in a news story on 7 June 2001 “Australians will each be \$8000 richer by the turn of the decade even with a carbon tax, according to figures Treasurer Wayne Swan will release today.” Shane Wright, Economic Editor, The West Australian ‘Richer years ahead with carbon tax: Swan’ (see <http://au.news.yahoo.com/thewest/a/-/newshome/9590502/richer-years-ahead-with-carbon-tax-swan/>) (There was one BCA release that actually said EVERY but I can’t find it now).

On markets

*This paper discusses the reliance on the concept of “markets” in the formulation of policy. It is not a fully referenced document and is intended to inform policy discussions.*¹

Context

Since the 1980s there has been in Australia a “reform” program that has put the reliance on markets and competition as a goal at the heart of policy discussions. The concept of the market has been championed as an alternative to central planning.

The perceived advantages of markets have been used as a basis for restricting the remit of Government in regulating economic activity.

This paper is one of a set that discusses the concept of “market” and “competition” as used in public policy. This paper contrasts the view of regulation as response to market failure with an alternative view that all markets are social constructions and that regulation is a task in market design.

Markets as social constructions

The theorists and policy makers use a language that “the market” or “markets” are to be preferred to the alternative, which is usually meant to mean centralised control by “the State”. The usage implies the existence of markets outside of any political or social construction.

The concept of a market depends upon the concept of property rights. One person “owns” something and another person “owns” something else and they think they’d both be happier if they traded. That is the atomic concept.

The first observation to make is that “property” (apart from perhaps a nest or cave) only has meaning to human beings. And only human beings have introduced the concept of social enforcement of the property right.

The fact that they are a human construction does not mean that they are the only possible construction. Indeed the earliest forms of social structure were communal. A feature of the earliest engagement of Australian aborigines with the first European settlers was the fact that the indigenes did not understand the idea that the property of the Europeans was not theirs.²

A wide sweep of history can show that various communal models have been as prevalent as markets.³

So markets exist as a social construction, and they are enforced by social rules. Simple observation shows that in the real world there are lots of different actually occurring markets all with different rules.⁴ Some are markets like stock exchanges where transparency of bids, and trades, and “fundamentals” are rigorously enforced. Some are like used car lots that practice price discrimination based on the preparedness of the buyer to haggle. Some are formal auctions, including classic open out-cry auctions.

Markets and market failure

The “market” as usually used in public policy is a reference to one specific kind of theoretical market, the one on which orthodox economics is founded.

This is a market with a sufficiently large (potentially infinite) number of buyers and sellers that no one individual can affect the price paid in the market. It is a market in which all sellers are offering a homogenous product, and in which all buyers are only seeking that

one product. It is a market in which buyers and sellers are perfectly informed before any transactions about the preferences of each other and in which all trades happen simultaneously.

The creation of an “ideal” is not unusual in science. The simple explanation of how billiard balls collide (conservation of momentum and energy) does not take into account friction on the ball in the air and loss of energy at collision (in both heat and noise). But we accept the explanation because it has good predictive power. At a more practical level the same calculations are used to assess motor vehicle collisions.

But there are plenty of occasions where the model is useless. These include the movement of sub-atomic particles, the movement of stars, or the movement of charged bodies in a magnetic field.

Theoretical models need to be constrained to use in the circumstances where the assumptions that support them apply sufficiently well to generate the outcome.

In public policy this has come to be labelled “market failure”. It creates a theory that markets should be left to operate, but if there is a “market failure” then there is a need for some central action to rectify the “failure”.

There exist a number of alternative lists of the different kinds of “market failure”; these include the existence of market power, the presence of externalities (including the case of “public goods”) and information asymmetry. To these can be added a concept of “friction”; the costs inherent in undertaking search and transactions that is usually excluded from the model.

John Kay has criticised the “market failure principle” because it both concedes too much ground to the validity of markets and because “the modern left has invested so much in market failure as its rationale for action, there is a temptation to frame everything they want to do as a response to market failure, however tenuous the basis for this may be.”⁵

The first of these addresses the fact that market failure is only addresses economic goals. Non-economic goals – such as distributional justice, paternalism and community values – are not captured at all.

Indeed the idea of distributional injustice to the extent that certain groups will be excluded from a market is sometimes incorrectly described as “market failure”. But they are really the consequence of the market working. Policies to ensure “universal access” are policies designed to counter working markets.

“Market failure” is ultimately a poor public policy construct because every real-world market falls short of the ideal of the theoretical market, and hence can be claimed to “fail.”

Markets and market design

One of the great champions of markets in the Post War era, Freidrich Hayek, contrasted the market with the alternative of collectivist action. For Hayek the problem of creating a rational economic order was the inability for a central agency to obtain the data necessary to make decisions. For Hayek, “The economic problem of society is a problem of the utilization of knowledge which is not given to anyone in its totality.”⁶

He continues;

If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. ...

Fundamentally, in a system in which the knowledge of the relevant facts is dispersed among many people, prices can act to co-ordinate the separate actions of different people in the same way as subjective values help the individual to co-ordinate the parts of his plan. ...

I am far from denying that in our system equilibrium analysis has a useful function to perform. But when it comes to the point where it misleads some of our leading thinkers into believing that the situation which it describes has direct relevance to the solution of practical problems, it is high time that we remember that it does not deal with the social process at all and that it is no more than a useful preliminary to the study of the main problem.

This extensive quote is intended to demonstrate two distinct versions of the value of markets. The first is Hayek's sense of markets as means to communicate information about preference. The second is in the formalism of equilibrium analysis wherein markets result in prices moving to reflect absolutely those preferences (as in price will equal marginal cost).

This distinction has been recently picked up by Kay in his 2009 Wincott Lecture. He states that in their approach to markets, economic researchers and policy-makers have focused too much on the role of prices as signals to guide resource allocation ... the role they play in equilibrium analysis. He claims this is at the expense of two possibly more important elements – markets as a process of discovery and markets as a mechanism for the diffusion of political and economic power.⁷

To be clearer about the distinction, market theory assumes a fully informed market that simultaneously clears. The real world is made up of dynamic markets with incomplete information. The actual trades that occur in one time period affect the preferences of participants in the next period.

If the preferences of the participants stay unchanged, the dynamic market will "settle" (or converge) on the position that applied in the static market. However, in many circumstances a market will not converge on that outcome.⁸

In public policy we need to accept that the reason for preferring markets is because of the process of information disclosure (discovery) and empowerment they offer, not because of the static efficiency outcome that the theoretical model describes.

The consequence is therefore to not imagine there is a perfect market and we only adjust for identified failure; instead policy needs to acknowledge that all markets vary from the ideal and that the ways they vary are constructed by social rules, including Government regulations.

Conclusion

The "market" of orthodox economic theory never exists. Regulating for market failure is a poor policy construct as it knows no bounds since all markets "fail", and it does not admit of the need for social regulation where the way the market works would result in social injustice.

However, markets are a preferable model of economic organisation over central planning because of their ability to work to transmit information (a function they are actually presumed not to have in the standard theory).

The focus of public policy needs to be on designing markets to achieve the objectives of facilitating discovery and constraining the exercise of power.

¹ Paper prepared by David Havyatt June 2011.

² Inga Clendinnen *Dancing With Strangers: Europeans and Australians at First Contact* Text Publishing 2005.

³ The reference here is to a book titled "Civilsation" the exact details I'm unable to locate...

⁴ See John McMillan *Reinventing the Bazaar: The Natural History of Markets* for examples.

⁵ John Kay 'The Failure of Market Failure' *Prospect Magazine* Issue 137 1 August 2007. At <http://www.prospectmagazine.co.uk/2007/08/thefailureofmarketfailure/> behind a paywall.

Republished in *Beyond New Labour: The Future of Social Democracy in Britain* Patrick Diamond and Roger Liddle (Eds) (<http://trove.nla.gov.au/work/28495907>)

⁶ Freidrich Hayek 'The Use of Knowledge in Society' *American Economic Review* Vol 35 No 4 September 1945 519-30.

⁷ John Kay 'The Future of Markets' *Economic Affairs* March 2010

⁸ For a full treatment of economic dynamics see Ronald Shone *Economic dynamics: phase diagrams and their economic application* Cambridge University Press 2002.

On competition

*This paper discusses the reliance on the concepts of “competition” in the formulation of policy. It is not a fully referenced document and is intended to inform policy discussions.*¹

Context

Since the 1980s there has been in Australia a “reform” program that has put the reliance on markets and competition as a goal at the heart of policy discussions. A recent example has been in the “framing paper” published as part of the Convergence Review². This paper and the proposed principles it is imbued with the language of competition.

The paper is correct in noting the role that the “encouragement of competition” has played. Before a review as significant as the Convergence Review continues it is worthwhile reviewing the acceptance.

This paper is one of a set that discusses the concept of “market” and “competition” as used in public policy. This paper contrasts the conception of competition as interpreted by courts and the concept of competition that underpins the policy theory.

Competition as policy

In October 1992, Prime Minister Keating asked a committee chaired by Fred Hilmer to conduct a review of National Competition Policy. The report of that committee is the most cited justification for the policy construct of competition policy.³

However, the report itself never particularly inquired into the merits of competition, as its Terms of Reference made the assumption that competition was good for the country and the economy.

Nevertheless the reports introduction did state some of the grounds for the belief;

If Australia is to prosper as a nation, and maintain and improve living standards and opportunities for its people, it has no choice but to improve the productivity and international competitiveness of its firms and institutions. Australian organisations, irrespective of their size, location or ownership, must become more efficient, more innovative and more flexible.

Over the last decade or so, there has been a growing recognition, not only in Australia but around the world, of the role that competition plays in meeting these challenges. Competition provides the spur for businesses to improve their performance, develop new products and respond to changing circumstances. Competition offers the promise of lower prices and improved choice for consumers and greater efficiency, higher economic growth and increased employment opportunities for the economy as a whole. (P. 1)

The report introduces many of the now well worn concepts about competition. The objective of competition policy is then briefly stated.

Competition policy is not about the pursuit of competition for its own sake. Rather, it seeks to facilitate effective competition in the interests of economic efficiency while accommodating situations where competition does not achieve economic efficiency or conflicts with other social objectives. These accommodations are reflected in the content and breadth of application of pro-competitive policies, as well as in the sanctioning of anti-competitive arrangements on public benefit grounds. (P. 6)

Competition policy in this construction is entirely focussed on the concept of “economic efficiency”, a concept which is poorly understood at best and is arguably highly deceptive.⁴

The statement is quite explicit that the policy seeks to “accommodate situations where competition ... conflicts with other social objectives.”

There are three aspects of competition as envisioned in these statements that are further explored below. These are the varieties of competition, the relationship between competition and markets, and the relationship between competition policy and social objectives.

The varieties of competition

The Hilmer report stated that

Competition may be defined as the "striving or potential striving of two or more persons or against one another for the same or related objects".(P.2 citing F.G.Dennis 'Competition' in the History of Economic Thought)

The report went on to analyse the components of the definition to stress the possibility that the competition was potential rather than actual and that two competitors might be sufficient. They also opined that the persons might not really compete against each other for the same objects, raising the possibility of competition by differentiation.

In doing so the report never reflected on the extent to which any of these things detracted from competition achieving the supposed outcome of “efficiency”. The only case in which efficiency was referred to was in contestability theory, a conclusion that subsequent research found was illusory in any case where there were “sunk costs”. It just so happens that in markets with one provider it is usually the sunk costs that create that outcome, hence making contestability irrelevant.

Interestingly the concept of competition that is the object of policy and legislation is not actually laid out in the Act. As a consequence it is judicial interpretation on which we rely. Two important definitions are

Competition expresses itself as rivalrous market behaviour. In the course of these proceedings, two rather different emphases ... Competition is a process rather than a situation. Nevertheless, whether firms compete is very much a matter of the structure of the markets in which they operate were placed upon the most useful form such rivalry can take. ⁵

Competition is a process and the effect upon competition is not to be equated with the effect upon competitors, although the latter may be relevant to the former. Competition is a means to the end of protecting the interests of consumers rather than competitors in the market⁶

Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to `injure' each other in this way. This competition has never been a tort...and these injuries are the inevitable consequence of the competition sec. 46 is designed to foster. ⁷

The first definition from the Australian Competition Tribunal actually traversed the territory of whether the rivalry had to be price based or could be non-price based. The second from the Federal Court introduces the idea that the impact on competitors is not the issue. The third definition from the High Court specifically permits the idea that the competition involves firms harming each other.

In this the courts interpret competition as an activity between firms rather than for customers.

An analogy for the distinction is available in sport. In a game of tennis, the two players confront each other, and the action of each depends directly on the action of the other, they are competing between themselves. In a game of golf the competitors all have the common goal of completing the course in the least number of strokes. While they pay attention to the kind of equipment each is using, and may make a decision about a specific shot depending on their assessment of how much risk their opponent will take or what their opponent does, the bulk of the effort is competing for a low score.

The latter kind of competition is the kind that market theorists will demonstrate generates efficiency. The legal definitions however rely far more on the former version.

And once competition reaches the point of each participant considering the action of the other you have the economic circumstances that immediately invalidate the theory of economic efficiency.

Competition and markets

The judicial interpretation extends to the concept of market as expressed in public policy. Indeed the judicial interpretation is that the relevant interpretation is ordinary English meaning, not the meaning of theory.

The concept of a `market' is a metaphor used to describe a range of competitive activities by reference to function, product and geography. The application of the metaphor may be informed by economic analysis, provided it is rooted in commercial realities. However, whether or not a particular corporation has market power, within the meaning of a provision such as s 46 of the Act, is not a matter to be resolved by debates between expert witnesses; the issue is raised by statutory words of ordinary English meaning which are to be construed and applied by the Court.⁸

Within the construct of trade practices law, the relation between markets and competition is that the market of relevant activity is first defined, and then the question of whether there is competition in that market is addressed.

There is nothing in this construct that facilitates the outcome of markets as tools for communicating preferences.⁹ Where competition exists as an exercise of producers exercising rivalry in their ability to attract consumers you get some way to achieving the benefits of markets.

The generally accepted outcome of competition, as described by Hilmer above, is the threefold benefit of lower prices, choice for consumers and innovation. The extent to which these outcomes will occur depends on the actual market design involved. It is not just a simple binary choice between the presence or absence of "competition".

Competition policy and social objectives

The benefit of competition policy offered by Hilmer was economic efficiency while accommodating the conflicting interests of social policy.

The single most commonly violated social policy by the application of competition policy is the consequence that some citizens will be denied access to relevant goods or services. This is very explicitly an equity goal, and falls outside the calculus of efficiency.

It need not do so however. There is a perfectly good theory that says it is in the economic interests of the well off to ensure adequate provision for the less well off, as it is a cheaper alternative than the enforcement against the crime that would otherwise occur as a consequence. That is, the social policy can be construed as an economic policy. However,

the very nature of the argument is that it is the kind of externality that typical markets do not manage well.

A consequence of this conflict can be seen in telecommunications policy, where a Universal Service policy is buttressed against a competition policy. This is generally contrasted with a pre-existing policy of national centralised monopoly that internalised the cross-subsidy.

But the fact that in a competitive market some consumers won't get served is not a "market failure", it is the market in operation.

Conclusion

The concept of competition used in public policy is founded too much on the concept of rivalry between providers rather than rivalry for customers. The relationship between markets and competition is configured as a market being the arena within which competition occurs, rather than the market being the mechanism for propagating information through the economy.

¹ Paper prepared by David Havyatt June 2011.

² The Convergence Review refers to an independent review "to examine the policy and regulatory frameworks that apply to the converged media and communications landscape in Australia" see http://www.dbcde.gov.au/digital_economy/convergence_review

³ National Competition Policy at <http://ncp.ncc.gov.au/docs/Hilmer-001.pdf>

⁴ See the DigEcon Research paper *On Efficiency*

⁵ Re Queensland Co-operative Milling Association Ltd., Defiance Holdings Ltd. (Proposed Mergers with Barnes Milling Ltd.) at

[http://www.accc.gov.au/content/item.phtml?itemId=784498&nodeId=c920ec0aa3b674f1723ea1dbd00f0281&fn=49.%20Queensland%20Co-operative%20Milling%20\(1976\)%20ATPR%2040-012.pdf](http://www.accc.gov.au/content/item.phtml?itemId=784498&nodeId=c920ec0aa3b674f1723ea1dbd00f0281&fn=49.%20Queensland%20Co-operative%20Milling%20(1976)%20ATPR%2040-012.pdf)

⁶ Universal Music Australia Pty Ltd v Australian Competition & Consumer Commission [2003] FCAFC 193 (22 August 2003) <http://www.austlii.edu.au/au/cases/cth/FCAFC/2003/193.html>

⁷ High Court in Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Company Limited & Anor.

A good general discussion is also at

http://www.kensingtonswan.com/Publications/Competition%20&%20Consumer/The_meaning_of_competition.pdf

⁸ Universal Music Australia Pty Ltd v Australian Competition & Consumer Commission [2003] FCAFC 193 (22 August 2003) <http://www.austlii.edu.au/au/cases/cth/FCAFC/2003/193.html>

⁹ See DigEcon Research paper *On markets*

On regulatory forbearance

*This short paper discusses the use of the term “regulatory forbearance” in the context of policy discussions. It is not a fully referenced document and is intended to inform policy discussions.*¹

Context

The term “regulatory forbearance” has made a resurgent appearance in policy discussions, at least in the telecommunications space. It was used by a number of people in the course of a discussion² of what principles and objects should underline the Convergence Review³. It has been used in New Zealand to describe a period during which new fibre investments would not be subject to Commerce Commission pricing decisions.⁴

The contention of this paper is that “regulatory forbearance” is a term of craft that specifically refers to an act of a regulatory agency and not to a piece of legislation. The paper goes on to argue that the distinction is important because the ability of a regulator to “forbear” provides an effective tool for creating commitment. The paper goes on to consider circumstances in which forbearance can be detrimental.

In brief the position of the paper is that “regulatory forbearance” should not be used as a synonym for no regulation or for an “access holiday”.

Regulation and regulators

Regulation is widely understood to refer to centralised decision making that replaces or directs outcomes that would otherwise occur in a market. In a separate paper the breadth of the use of the term will be more broadly considered, but this definition is sufficient for this paper.

In economies with a strong constitutional form of government and “the rule of law” regulation is achieved by the passage of appropriate instruments according to the constitutional requirements. In the Westminster system as operating in Australia this entirely depends upon the passage of legislation by the relevant Parliament (from here on the discussion will assume national regulation). The legislation may empower the Governor-General in Council, or a Minister or a specified agency to make further rules by sub-ordinate instrument. These instruments are, confusingly, sometimes known as “regulations” but they can be “determinations”, “declarations” and a variety of other terms.

These rules collectively are the “regulations” from an economic perspective. Enforcement of rules ultimately relies on the ability of someone being able to decide a rule has been broken and that some consequence must occur. This body is a court (within certain contestable limits) to ensure the separation of judiciary from executive and legislative government.

Outside of the rules themselves and the courts there may or may not be additional bodies called “regulators”. Regulators have differing degrees of powers. In the USA some regulators have extensive executive powers as the legislature has sought to remove these from the President. In Australia the executive powers are usually more circumspect.

Regulators have specific defined tasks:

1. They can make new rules (sub-ordinate instruments) as permitted by their governing legislation; and
2. They are usually empowered to initiate action in a court to determine if a rule has been broken.

Ultimately a regulator's day is made up of a host of other things, but these are things done in support of the above. Those other things include monitoring and reporting on the state of the things that they regulate, they communicate with others about what the regulation is supposed to achieve and conducting inquiries in relation to the rules generally or a breach in particular; and they provide certain administrative machinery to facilitate the operation of the rules (such as licencing regimes, acceptance of undertakings, publication of registers).

One particular power is to reach agreement not to pursue court action on the basis of the party agreeing to an agreed remedy.⁵

Within this framework the concept of "regulatory forbearance" is understood to be an active decision by a regulator to not do one of the things it can do (make an instrument or prosecute) when it could otherwise do so. It does not mean denying the regulator the ability to make that decision. This accords with the definition "Refraining from doing something that one has a legal right to do"⁶

The ITU's "Regulatory toolkit" says;

The concept of regulatory forbearance has two elements:

- *A regulator may refrain from applying certain regulatory conditions or from intervening in certain markets. For example, the Canadian Radio-television and Telecommunications Commission has explicitly stated that it will forbear from regulating certain services.*
- *A regulator may reduce the scope of regulation or withdraw entirely from regulating specified markets.⁷*

The process of legislation not empowering a regulator to do something is different from the concept of a regulator "forbearing" to use a power they have.

Why the ability to forbear matters

The promoters of regulation in all sectors share a common failing. This is the belief that merely passing a law (creating a rule) automatically results in that rule being obeyed. If they find it doesn't work they either suggest tightening the rule or increasing the penalty.

A simple example is the problem of drink driving. Creating the law alone doesn't stop it. It is not uncommon to see after a case of a fatality due to drink driving to see calls for a reduction in the permitted alcohol level (even though the offender was already over the existing limit) or tougher penalties (though clearly the offender was oblivious to any penalty).

What we are really trying to affect is behaviour, and the rule itself is only one device. Advertising campaigns explaining the personal risk and consequences are therefore another tool used. These campaigns will go as far as targeting the friends of potential offenders as more likely to have an effect than directly advertising to potential offenders.

Regulation of economic activity is no different, the ultimate goal is to achieve a certain kind of behaviour. In achieving these outcomes a regulator is confronted by exactly the same kind of reputation issues as a firm trying to promote its brand.⁸

The effectiveness of reputation can be observed in the "that the monetary policies of more independent central banks tend to be less inflationary and less activist."⁹ The situation in Australia today of a central bank with a very clear statement of expectations about the expected outcome of monetary policy results in a market that adjusts its behaviour.

When inflationary pressures build market interest rates can actually increase prior to an official rate rise, sometimes to the extent of forestalling the need for a rise.

This example of “regulatory commitment” demonstrates the value of a highly powered regulator combined with very clear policy goals. The regulator in this case is able to forbear on a rate rise because the market adjusts to the circumstances itself. The publication of Board minutes adds to these inbuilt “self-regulatory” mechanisms.

The significant difference between an empowered regulator exercising forbearance and the alternative of the potential for additional legislation is the speed with which the relevant act could occur, and hence the affected parties to believe the commitment of the regulator and/or policy maker to the relevant goals.

Empowering a regulator with effective powers, a clear objective and the ability to exercise forbearance enables the creation of credible reputation for the regulator, and the ability to obtain the desired behaviour with minimal action (meaning intervention).

The risks

There are two risks with creating a regime in which forbearance is a tool provided to the regulator. The first and most obvious is the potential for an excessively activist regulator who simply fails to forbear. There are two defences against this. The first is clarity of the objective set for the regulator and the second is existing administrative law constraints that can be applied.

The second risk is a regulator that excessively forbears. This has two potential consequences, the first being an obvious enforcement failure but the second is a potential regulatory creep.

The potential enforcement failure is already evident in the case of existing regulators. The ACMA and ACCC have regularly been complained about for their failure to enforce aspects of the rules. ASIC has been criticised for failing to prosecute for unconscionable conduct.¹⁰

There appears to be few effective mechanisms to seek redress from inactive regulators. The Australian Communications Consumers action Network has proposed the adoption of a concept called a “super complaint” lodged by a representative body. An alternative would be to complain to the Commonwealth Ombudsman – though complaints here are usually about excessive rather than insufficient action.

The possibility of regulatory creep can occur if the regulator effectively convinces too many parties to “cop it sweet”. It is not unusual for firms to accept the punishment while still protesting their innocence.¹¹ It is possible that the cumulative effect could be behaviour constrained well beyond that envisioned in policy.

Conclusion

The term “regulatory forbearance” has a very specific meaning that should be preserved. Providing regulators with sufficient powers and clear enough objectives to practice forbearance is likely to be a better way to achieve policy objectives than to avoid regulation.¹²

It has not been discussed here but the provision for regulatory forbearance provides the opportunity to guide market development in cases of significant innovation and technology development.

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¹ Paper prepared by David Havyatt. This version of the paper was published on 19 May 2011.

² This discussion occurred at the Network Insight Institute seminar “Internet, Telecoms and Convergence: the legal and policy challenge” held on 9 May 2011 see http://www.networkinsight.org/events/9_may_2011.html/group/7

³ The Convergence Review refers to an independent review “to examine the policy and regulatory frameworks that apply to the converged media and communications landscape in Australia” see http://www.dbcde.gov.au/digital_economy/convergence_review

⁴ Steven Joyce Media Release ‘Regulatory forbearance to be replaced’ 18 May 2011 at <http://beehive.govt.nz/release/regulatory-forbearance-be-replaced>

⁵ While the ability to “settle out of court” is usually accepted it doesn’t always apply. For example in a criminal case the accused can plead guilty but the court still determines the punishment. As will be discussed later the power to not prosecute can be of equal public policy concern.

⁶ West’s Encyclopaedia of American Law

⁷ ITU *ict regulation toolkit* section 2.3.5 at <http://www.ictregulationtoolkit.org/en/section.1679.html>

⁸ Eduardo Faingold and Yuliy Sannikov ‘Reputation in Continuous-Time Games’ *Econometrica* Vol 79 No 3 (may 2011) 773-786.

⁹ Susanne Lohmann ‘Optimal Commitment in Monetary Policy: Credibility versus Flexibility’ *The American Economic Review*, Vol. 82, No. 1 (Mar., 1992), pp. 273-286

¹⁰ Evan Jones ‘Bank’s SME story doubtful’ *Australian Financial Review – Letters* 18 May 2011.

¹¹ See Lucy Battersby ‘Watchdog hits Optus with fine for misleading ads’ *Sydney Morning Herald* 19 May 2011.

¹² There are some who would think the “regulatory pyramid” is a version of the regulatory forbearance philosophy discussed here. That is the concept that you give industry a chance to self-regulate before you directly regulate. True forbearance requires that the consequence of inaction is more than just the regulation that could have occurred anyway. As an example, the forebearance approach to mobile premium services would have been to not regulate, but to start prosecuting the mobile carriers for their complicity in harm (if any) to consumers.

About DigEcon Research

Purpose

DigEcon Research is a stand alone research body. Ultimately, its pursuit is policy research, the focus of which is the meaning and significance of the Digital Economy. This policy research encompasses both economic and social research.

Researching the significance of the Digital Economy

The concept generally referred to as the Digital Economy is frequently discussed but there is little shared meaning in the term. A key definitional issue is whether the Digital Economy is something yet to happen or in which we are now embedded.

DigEcon Research focuses on the analysis of social and economic change rather than an analysis of a notionally static "Digital Economy". Analysis of the change as it occurs should highlight those areas where there is genuine policy choice rather than merely a need to adapt policy to changes that have already occurred.

Before Thomas Kuhn popularised the idea of "paradigms" J.K.Galbraith railed against the "conventional wisdom". There is no denying that what Kuhn called "normal science" or the repeated application of existing theory to new problems results in most practical developments. It is equally true that the application of existing theory to problems they were not designed for results in, at best, vacuous solutions and, at worst, wildly dangerous outcomes.

The Digital Economy challenges the fundamental concepts of neo-classical economics. It also challenges most of the precepts of how societies are organised. In this context policy research needs to focus on what is different, not on what is the same. The Digital Economy is not just a matter of means of production but about the fundamental structures of social organisation.

Work program

This research is designed both to inform policy makers and to assist those who would seek to influence policy makers or to make business decisions. DigEcon Research however does not provide strategy recommendations nor undertake policy advocacy on behalf of any party.

A key element of the research will relate to the direct regulation of the converging industries of telecommunications, media, consumer electronics and information technology. However, the agenda encompasses the wider economic and social policy issues.

The scope of the research agenda will ultimately depend upon the researchers who wish to participate in what is more an idea than an entity.

In the crowded Australian research field there are a number of "bodies" that share some of the objectives of DigEcon Research. DigEcon Research aspires to contribute to the work of these and any other researchers in the field.