Economic rationales for regulating markets

Introduction

This is the fourth article in the Scrutiny Unit's *Economics in Practice* series[1]. This note outlines reasons why markets are regulated, and some of the possible trade-offs involved in achieving different regulatory objectives. It also summarises recent Government policy developments in this area, picking out recent developments in health, finance and education in particular.

This note may be useful for those interested in areas where regulation is being introduced, or being reviewed.

Reasons for intervention in markets

In theory, a well-functioning market should maximise value for consumers. This is because firms that do not deliver value for money will not be able to attract customers and survive in the market.

However, there are reasons why markets may not work perfectly, or may not achieve the desired outcome from society's point of view. Where this is the case, it may sometimes be beneficial for Governments to impose regulation in the market, if the benefits of such intervention to society are likely to exceed the costs.

Examples of possible rationales for intervention are:

Weak competition

A firm with significant market power (in the extreme, a monopoly), would face relatively little competitive pressure. This could result in high prices for consumers, and potentially fewer incentives for firms to offer choice and to innovate[2]. Firms may also engage in anti-competitive behaviour, to the detriment of consumers. For example, firms might collude to keep prices high, or try to prevent other firms from entering the market.

Externalities

An externality is an impact on a third party who is not directly involved in a particular transaction. For example, a factory might cause pollution which could damage the environment, impacting a range of people not directly involved in the decision taken by the factory to manufacture a particular product. This would be an example of a negative externality. An example of a positive externality would be vaccinations: if one person is vaccinated, they are less likely to catch the disease, but are also less likely to pass the

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[1] Previous articles covering health care, house prices and public sector pay are available here: http://www.parliament.uk/mps-lords-and-offices/offices/commons/scrutinyunit/reports-and-publications/

[2] The evidence suggests that the impact of competition on innovation varies. Overall, the evidence suggests that the relationship between the two is "u-shaped": in a very competitive market, firms may be unable to make a sufficient return to compensate for risks associated with research and development. However, at the other extreme, when a firm faces no competition at all, it has little incentive to innovate, as the rewards of producing a better product would be limited in terms of the additional market share it could achieve. There is therefore a "sweet spot" with just enough competition to give firms an incentive to innovate, but not so much competition that it is difficult to earn a return.

disease on to any other people that they come into contact with. So the decision to be vaccinated benefits other people not directly involved in the decision.

Lack of information and/or difficulty making informed decisions

If consumers do not have adequate information to make informed decisions, they may not be able to make the best choices for their needs. In some cases, even when a consumer has made a purchase, it may be difficult for them to assess the quality of the product, or whether the service they are receiving matches their needs. This is more likely where understanding how a product or service works requires particular expertise, for example, medical procedures or car repairs.

Even if they do have access to information, consumers may find it difficult to use the information to make decisions, or for various reasons, make decisions that are not in their best long term interests. This could be the case for long-term financial products for example, pension schemes, where it may be difficult for individual consumers to assess the costs and benefits of different products.

If consumers do not have sufficient information, or find it difficult to make informed decisions, firms face less competitive pressure, and the market is less likely to deliver value for consumers. In some cases, the detriment may be more serious, for example, if consumers are unaware of inadequate water quality, or the safety of the food products they are consuming.

Social objectives

It may be considered unfair that only those able or prepared to pay are provided with a good or service, as would happen in an unregulated market. For example, it may be considered desirable that all members of the public have access to essential services such as water, energy and healthcare. It is worth noting that in some cases, the provision of a good or service may be considered socially desirable partly because, in addition to the argument relating to fairness, there are positive externalities.

In some cases, social objectives are achieved through state funding. In other cases, they are achieved by placing regulatory obligations on firms (for examples, see table below).

Although often resolved by state provision rather than regulation of an existing market, *public goods* are another reason why markets may not achieve socially desirable outcomes. In economics, a public good is defined as a good for which:

- Consumption by one individual does not reduce the availability of the good for others
- Once the good is provided, it is not possible for an individual to be excluded from consuming it.

Defence would be an example of a public good which is provided by the state.

The table below sets out examples of regulation designed to solve some of the “market failures” outlined above.

	Examples of regulation
Weak Competition	The Competition Commission investigates mergers that may impact competition. The Office of Fair Trading (OFT)[3] conducts market studies and investigates potential anti-competitive behaviour. Utility regulators may set prices for some services, which might otherwise be priced too high. Examples of utility regulators are Ofcom, Ofwat (in England and Wales), Ofgem, the Office of Rail Regulation and the Northern Ireland Authority for Utility Regulation.
Externalities	The Climate Change Levy taxes the use of energy, thereby bringing the market's use of energy closer to socially desirable level[4].
Lack of information and/or difficulty making informed decisions	The Financial Services Authority mandates certain types of information disclosure when selling financial products.[5] In England, Ofsted inspects and publishes its findings on education services, thereby providing more information to the public (Estyn, HM Inspectorate of Education and Education and Training Inspectorate perform similar roles in Wales, Scotland and Northern Ireland respectively).[6] The Food Standards Agency enforces food safety rules[7]. The Pensions Regulator monitors work-based pension schemes and can impose penalties if schemes do not comply with regulations to protect members' benefits. Individual pension members would find it difficult to monitor this themselves due to the level of information and expertise required.[8]
Social objectives	The Warm Home Discount Scheme requires energy companies to give discounts on energy bills to a core group of vulnerable customers.[9] Royal Mail has a universal delivery service obligation whereby it must deliver mail to every UK address every working day[10].

[3] The Government is currently consulting on whether to merge the competition functions of the OFT and Competition Commission (Competition commission website: http://www.competition-commission.org.uk/ OFT website: http://www.oft.gov.uk/)
[4] http://www.decc.gov.uk/en/content/cms/emissions/ccas/cc_levy/cc_levy.aspx
[5] http://www.fsa.gov.uk/Pages/Doing/Regulated/newcob/disclosure/index.shtml Note that the Government has proposed changes to the financial regulation landscape, as outlined in the annex.
[6] Ofsted website: http://www.ofsted.gov.uk/ ; Estyn website: http://www.estyn.gov.uk/ ; HMIE website: http://www.hmie.gov.uk/; ETI website http://www.etini.gov.uk/)
[7] http://www.food.gov.uk/
[8] http://www.thepensionsregulator.gov.uk/regulate-and-enforce/regulatory-activity.aspx
[9] http://www.decc.gov.uk/en/content/cms/news/pn10_121a/pn10_121a.aspx
[10] http://www2.royalmail.com/customer-service/universal-service&campaignid=USO

Generally, economic regulation refers to intervention designed to affect market decisions made by firms and individuals, for example, pricing rules or intervention to affect the level of competition in a market.

Government has described the aim of economic regulation as "to create a system of incentives and penalties that aim to replicate the outcomes of competition in terms of consumer prices, quality and investment and puts the protection of consumers' interests at its heart."[11]

Trade-offs in regulation

In many cases, there are likely to be trade-offs between different objectives in regulation. Designing the correct regulatory framework for a particular market needs to reflect the particular features of the market, and areas of most concern. For example:

Benefits of regulation versus the costs

Regulation may result in some benefits, but can also increase firms' costs, which may ultimately be passed on in the form of higher prices. For example, it has been argued that certain requirements on bank capital and liquidity could result in increasing costs to consumers, such as higher costs of credit[12]. In addition, administering and enforcing regulation can result in higher costs to the taxpayer. In some cases, it may not be proportionate to impose regulation.

Strengthening incentives versus continuity of service

Allowing the possibility that firms might fail can strengthen firms' incentives to deliver value for consumers. However, in the event of failure, consumers may be negatively affected if continuity of service cannot be guaranteed. The importance of continuity depends on the good or service in question: for essential services such as water and energy it is likely to be more important. If continuity is important, further regulation or Government intervention may be required to address this trade-off, to ensure some degree of consumer protection if a firm fails. An example is the Pension Protection Fund, which certain employer pension schemes are obliged to contribute to, and which provides compensation to pension scheme members in the event of an employer becoming insolvent.

Low prices versus incentives to invest and innovate

Prices can be regulated to ensure that they are not too high. However, regulating prices too tightly may not give firms sufficient incentives to invest and innovate. This is likely to be of particular concern in sectors where the potential for benefits from research and development is large, such as information and communications technology or pharmaceuticals.

Protecting consumers versus product innovation

In some sectors, regulation may be required to ensure that products and services are of a minimum quality standard, for example, compliance with safety requirements. In other sectors such as the financial sector, there may be limits on the types of products that can be sold to consumers, to avoid the risk of vulnerable consumers purchasing products that are

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[11] BIS, Principles for Economic Regulation, April 2011
[12] Independent Commission on Banking, Interim Report, April 2011

not suitable for them. However, poorly designed regulations that impose costs on firms and restrict their actions could limit their ability to innovate and experiment with new products.

Benefits to one group of consumers at the expense of others

In some cases, regulation may benefit some groups of consumers, but impose costs on others, for example, an obligation to serve a particular group of customers could benefit those that the market would not otherwise reach, but may increase firms' costs, which may be passed on in the form of higher prices to all consumers, or in some cases, might be borne by the taxpayer. For example, BT currently has an obligation to provide a connection on reasonable request at uniform prices, subject to a certain cost threshold. In responses to previous Ofcom consultations it has noted the need for a cost threshold to ensure that "customers with exceptionally costly requirements are not inappropriately subsidised by the vast majority of customers"[13].

Recent Government policy developments

The Coalition Government has reviewed the general approach taken to regulation, and in particular emphasised the need to avoid unnecessary regulation. It has also looked in detail at some particular areas, including financial regulation, health (as part of the *Liberating the NHS* review) and education.

Reducing Regulation Made Simple

In December 2010, the Better Regulation Executive (BRE) published "Reducing Regulation Made Simple[14]", which set out the Government's strategy for achieving the right balance in the regulatory system. In particular, the document sets out the Government's aim to "eliminate avoidable burdens of regulation and bureaucracy", by:

- Removing existing regulation that unnecessarily impedes growth;
- Introducing new regulation only as a last resort;
- Reducing the overall volume of new regulation;
- Improving the quality of the design of new regulation;
- Reducing the regulatory cost to business and civil society groups; and
- Moving to a risk-based enforcement regime where inspections are minimised.

In addition, the Government aims to improve European regulation, and reduce the burdens it imposes.

The Reducing Regulation Made Simple also set out the "one in one out rule" which means that no new primary or secondary UK legislation which imposes costs on business or civil society organisations can be brought in without the identification of existing regulations with an equivalent value that can be removed.

[13] BT response to Ofcom consultation on the review of the Universal Service Obligation, March 2005
[14] Available here: http://www.bis.gov.uk/assets/biscore/better-regulation/docs/r/10-1155-reducing-regulation-made-simple.pdf

Principles for Economic Regulation

On the more specific area of economic regulation, the Department for Business, Innovation and Skills published "Principles for Economic Regulation" in April 2011[15]. The initial scope of these Principles was the economic regulation of infrastructure sectors (telecoms, postal services, gas & electricity, water, aviation and rail). However, the document also noted that the Principles would have broader relevance in some instances, highlighting in particular the regulation of qualification, examinations and assessments, and the future economic regulation of healthcare services.

The document set out Government's Principles for Economic Regulation, outlining the need for accountability, focus, predictability, coherence, adaptability and efficiency. In addition, Government set out a number of commitments, which covered:

- The clear division of responsibilities between Government and regulators
- Reaffirming the independence of regulation
- Steps to achieve coherent, adaptable but stable regulation
- Reinforcing regulatory accountability
- Ensuring clarity and focus of regulators' objectives
- Efficient and proportionate regulation
- Encouraging cross-sector working by regulators
- Embedding the Principles for Economic Regulation set out above.

Separately, the Government is consulting on changes to the competition regime, and a proposal to merge the competition functions of the Office of Fair Trading and the Competition Commission[16].

The following annex outlines recent regulatory developments in three particular areas: health, finance and university education.

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[15] Available here: http://www.bis.gov.uk/assets/biscore/better-regulation/docs/p/11-795-principles-for-economic-regulation

[16] Consultation available here: http://www.bis.gov.uk/assets/biscore/consumer-issues/docs/c/11-657-competition-regime-for-growth-consultation.pdf

Regulation in the healthcare sector

There are a number of reasons why the market for health care would not necessarily deliver socially desirable outcomes without Government intervention, which are described in more detail in the first Economics in Practice note, "Why is there public provision of healthcare?[1]" As described in the note, the argument that healthcare is a basic human entitlement, along with the positive externalities that are associated with healthcare, provides a rationale for Government subsidy and the existence of the NHS.

However, even with a publically funded health service, there are other aspects to health care, that mean that socially desirable outcomes may not be achieved. These can provide further rationales for regulation or intervention to structure the market in a particular way. These are:

- It can be difficult for individuals to assess the quality of care provided, and make choices based on this.
- A very large provider of health services may not face sufficient competitive pressure.

Both these factors mean that there may be fewer incentives for services to deliver value for money, both in terms of high quality care and cost efficiency.

In *Liberating the NHS*[1], the Department of Health set out measures to increase competition in the provision of health services, by allowing "any willing provider" to offer NHS services. It was proposed that Monitor will become an economic regulator with three core functions: promoting competition, setting or regulating prices and supporting the continuity of services. The Care Quality Commission would have a strengthened role to inspect providers and ensure that they comply with safety and quality standards. Recently, some changes have been made to the original proposal, following recommendations of the NHS Future Forum report. In particular, Government has decided to change the focus of Monitor towards protecting and promoting the interests of patients rather than promoting competition as an end in itself[2].

In theory, promoting a competitive market should be beneficial for patients. However, there are some potential issues and trade-offs that are relevant to the detailed design of the regulatory framework, for example:

- Increasing the ability of health providers to enter a market is not sufficient to create a competitive market without the availability of information to make informed choices. This is an area the Government is looking at as part of its *Liberating the NHS* work.
- To some extent, as described earlier, there may be trade-offs between strong incentives for firms to deliver value for money and ensuring continuity of services. It is proposed that there should be a mechanism in place for managing the failure of a provider, which protects patient services but not ineffective management or poor quality care.
- In setting prices for health services, which Monitor would have the power to do, there may be a number of potentially conflicting objectives, such as affordability versus allowing a sufficient return on investments in research and development.

[1] Available here: http://www.dh.gov.uk/prod_consum_dh/groups/dh_digitalassets/@dh/@en/@ps/documents/digitalasset/dh_122707.pdf

[2] Government response to the NHS Future Forum report

Financial regulation

The financial sector plays an important role in the wider economy in facilitating transactions, providing deposit-taking facilities, lending and enabling households and businesses to manage risks and their financial needs over time. Because the financial sector is strongly interconnected, the failure of one institution can increase the likelihood of others failing. This means that there may be negative externalities when a bank fails, or as noted by the Independent Commission on Banking[1]:

"...the failure of a systemically important bank which provides critical financial services and which is heavily connected to the rest of the financial system and the wider economy has particularly high costs. Because not all of the costs of a bank's failure are borne by its owners, creditors and managers, banks are likely to take on more risk than is good for society as a whole, unless their structure and conduct is carefully regulated."

In addition, for individual consumers in particular, it can arguably be difficult to choose the best financial products for their needs, and the costs of an incorrect decision can be very high, for example, with a mortgage or pension product.

A potential trade-off can exist between imposing regulation to increase stability and protect consumers, and allowing firms room to innovate. The recent financial crisis which began in 2007 has arguably put more emphasis on the former objective. In particular, HM Treasury has said that "the crisis was caused by the failure of financial institutions to manage themselves prudently, and of regulators to spot the risks that were building up across the system as a whole[2]".

The Government has published a draft bill[3], and outlined a number of measures and proposed changes to the regulatory framework as a result of problems highlighted by the crisis. These include:

- **Reforms to the UK's financial regulatory institutions**. A Financial Policy Committee, with responsibility for stability and resilience of the financial system as a whole, is to be established in the Bank of England. The Prudential Regulation Authority will regulate financial institutions that manage significant risks. The Financial Conduct Authority will have responsibility for facilitating efficiency and choice in services, consumer protection and protecting and enhancing the integrity of the UK financial system.
- **Setting up the Independent Banking Commission,** to consider the structure of the banking market and competition issues. The report is due in September 2011. The April interim report discussed the extent to which retail banking should be ring-fenced, how banks can be structured to better absorb losses, and measures required to increase competition in banking.

[1] Consultation on Reform Options, Interim report, April 2011 available here: http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf
[2] A New Approach to Financial Regulation: building a stronger system, HM Treasury, February 2011
[3] A New Approach to Financial Regulation: the blueprint for reform, HM Treasury, June 2011

Universities and regulation

Like health, education is another area where it may be considered socially desirable to ensure “fair” access. It could also be argued that society in general benefits from a well-educated population as it increases productivity (i.e. there may be externalities). However, without intervention, affordability could be a constraint for those on low incomes.

Another potential issue is that it may be difficult for potential students to adequately assess the quality of education provided across different institutions without some level of information provision.

Government has proposed changes to the way universities are funded and the ability of intuitions to offer degree courses, as set out in *Higher Education: Students at the heart of the system*[1]. The paper suggested that currently there was an “intrusive burden of regulation” and that an important theme of the paper was enabling greater competition while removing unnecessary regulations.

In terms of regulatory policy, some of the main proposed changes are described below.

- Institutions intending to charge more than £6000 annual tuition fees need to demonstrate what they will do to attract students from under-represented groups. The Office of Fair Access (OFFA) approves and monitors institutions’ access agreements[2].
- Currently, there are controls on the number of full-time undergraduate students that institutions can provide places to, with penalties for over-recruitment. Although there is a need to control costs to the public purse, the Government has argued that the current system prevents institutions from expanding to meet demand, and that reforms to the controls are therefore needed.
- The Quality Assurance Agency for Higher Education (QAA)[3] conducts reviews of universities and colleges and checks how well they meet their responsibilities. The Government is proposing a risk-based approach to quality assurance, allowing the potential for deregulatory change for institutions that can demonstrate low risk.
- Currently, Government grants the power to award degrees and take on the title of “university”. This is one way of safeguarding standards and quality. However, Government has argued that this can act as a barrier to entry into the market for new institutions that may be able to offer a valuable service but do not fit the traditional university model. Government is therefore proposing to make the criteria for allowing an institution to grant degrees and use the title of “university” more flexible.

[1]Available here: http://www.bis.gov.uk/assets/biscore/higher-education/docs/h/11-944-higher-education-students-at-heart-of-system
[2]http://www.offa.org.uk/about/
[3]http://www.qaa.ac.uk/

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