Market governance: competition policy and business conduct regulation

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In summary

- No necessary tension between competition policy and more sector-specific conduct regulation.
- Key is to be guided by the central purpose/function of markets, the facilitation of mutually beneficial exchange transactions.
- Things go wrong when sight of this purpose/function is lost or its significance is discounted.
- More often (though not always) the case for conduct regulation than for competition policy: regulation can then easily come to hinder, rather than to facilitate, trade.

The nature of markets

A shared/collective, stable (but mutable) *system of rules*

governing conduct in a way that *serves to facilitate*

mutually beneficial *exchange transactions* between economic agents

Note the three elements: (i) a system of rules, (ii) purpose/function (spirit) of the rules and (iii) domain of the rules.

Governance issues

- Concerned with the formal aspects of the rules (noting that many aspects of transactional behaviour are covered by informal 'rules': social norms, conventions, etc. – the 'commercial culture'), including governance of rule-change over time.
- Competition laws are an aspect of the rules focused on obstacles to transactions (restrictions of trade) associated with market power (i.e. an imbalance of power between buyers and sellers).
- Another feature of these laws is their generality: they apply across different markets (a much wider domain) and in that sense are not context dependent, although enforcement requires attention to context.
- Sectoral regulation, in contrast, tends to have a more limited domain.

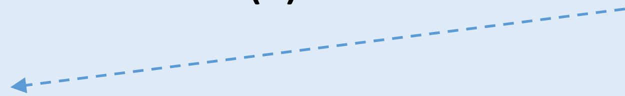
Static and dynamic issues

- A well functioning market is simply one that serves the central purpose (of the institution) well. It is effective in facilitating exchange transactions.

- Static issues:

  Specific commercial context -> well functioning market rules
- Dynamic issues:

  Commercial context (t) -> market rules (t)



  Commercial context (t+1) -> market rules (t+1)

  [*Tomorrow's context will depend, in part, on today's rules*.]

- Advances in economic welfare tend to depend chiefly on the dynamics.

Markets and algorithms

- Most policy thinking is of the form: here is a problem, what is the solution?
- E.g. here is an adverse effect on competition (AEC), what is the remedy or package of remedies (i.e. the change in market rules that will resolve/alleviate the problem)?
- Most complex problems are far too difficult to solve/remedy in this way. In mathematics complexity is dealt with algorithmically: a set of rules is developed that, when followed, tends to lead to *sequentially better* outcomes.
- In relation to resource allocation, market rules operate in this way – via sequential gains from voluntary trade among economic agents.

Differences in perspectives / modes of thinking

- More generally, a traditional approach is of the form: here are some targets, here are some instruments, how do we match the instruments to the targets? (Tinbergen).
- There are well known problems with the approach (Mundell):
  - There are always other, conflicting targets: identified targets tend to be narrowly specified, leading to 'policy externalities' (i.e. governance that is not joined up: a decision by department/regulator A worsens trade offs for Department/regulator B in ways that are unexamined).
  - The approach implicitly assumes that only targets/outcomes matter – there is indifference among instruments (means don't matter, which is not usually the case).
- But the killer point is that economic policy problems are frequently too complex to solve in this way.
- Compare with an approach that asks: here is an issue, how might we change market rules to establish a better, iterative, discovery process?

Statics and dynamics again

- Lower transactions costs are an aspect of improving discovery processes: they lower the cost of incremental improvements achieved via sequences of individual exchange transactions.
- But we shouldn’t forget that economic contexts change and that tomorrow’s context will partly depend upon today’s market rules.
- Today’s market rules may be effective for today’s context, but may be inappropriate for tomorrow’s, leading to ‘stranded regulation’. Worse, they may impede future realization of gains from trade, e.g. by impeding experimentation, invention and innovation.
- The dynamic effects require explicit consideration.

A formidable challenge

- Algorithms are directed at a particular problem, e.g. solution of the equations of general relativity for specified boundary conditions (the physicists’ analogue of ‘context’).
- But in economic life the context keeps changing, so the policy issues keep changing and in ways that are both uncertain and partly affected by today’s rules. Market governance issues might be said to be super-algorithmic in nature.
- *“Professor Planck, of Berlin, the famous originator of the Quantum Theory, once remarked to me that in early life he had thought of studying economics, but had found it too difficult!”* (Keynes)

Examples: consumer engagement and business conduct regulation

- Consumer engagement
  - Much focus on active/inert consumer distinction, rates of switching, etc.
  - But ‘actions’, including switching, imply additional transactions costs.
  - What is the difference between an inert/disengaged consumer and a consumer with a strong preference for ‘convenience’, e.g. because of a high opportunity cost of time (i.e. a consumer with better things to do)?
- Conduct regulation
  - Focus on businesses behaving badly.
  - But prescriptive regulation that imposes high compliance costs also serves to raise transactions costs (costs of exchange).
  - Can also hinder innovation by existing suppliers and raise barriers to entry (by raising costs of trading with future potential entrants who are often the source of innovations).

What is to be done?

- Always remember the central purpose: *facilitation of mutually beneficial exchange transactions, both in current contexts and contexts that might potentially develop in the future.*
- There is always plenty to be done in relation to satisfying the 'mutually beneficial' condition (wrt fraud, misleading information, etc.) Ditto in relation to market power that serves to restrict trade.
- Market rules are always with us: advocacy of simple deregulation is beside the point. Freer markets typically require more rules, not fewer.
- Rather the point is that governance performance deteriorates *when sight of the central purpose/function of market rules is lost.*

Two common problems with economic advice

- Economic advice normally points out the costs of alternative options, but it often shares a rather general cognitive bias towards overweighting current contexts (statics) and underweighting emerging contexts (dynamics) – arguably arising from Kahneman and Tversky's 'availability heuristic'.
- But the advice also tends to have a second, more idiosyncratic bias, in this case arguably associated with an economics education dominated by examination of models that *assume* that transactions costs are zero.
- Done to ease of analysis – to deduce analytic solutions and calculate optima – but it carries the implication that, if the assumption were true, markets wouldn't exist!
- That is hardly a useful starting point for assessing market governance issues. It is not of this world, hence the designation *Nirvana economics*.

Example: potential sources of competitive harm in CMA Market Investigation Guidelines

- Para 170 lists these sources as:
  - Unilateral market power
  - Barriers to entry and expansion
  - Coordinated conduct
  - Vertical relationships
  - Weak consumer response
- Misses the elephant in the room: market rules that are failing to serve their central purpose.
- The CMA’s energy Panel is to be commended for paying more attention to the elephant than has any of its predecessors, but when the Panel’s work is done the CMA could, usefully and at very low cost, correct a major cognitive bias and assist its successor panels via explicit identification at para 170 of the elephant’s seemingly ubiquitous presence. Ditto in relation to any guidance issued in relation to the conduct of Market Studies.