Regulation and competition

Swedish Agency for Economic and Regional Growth

Economic Policy and Business Activity

2018/2019, 2nd semester

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Competition is generally recognized as a crucial driver of economic growth. Rules and regulation, in turn, are a pre-condition for the functioning of markets and enabling competition. However, regulation can also negatively impact on competition in several ways, including by limiting the number of suppliers in the market or limiting the incentives or ability of firms to compete

The work will follow the next topics :

-Competition, regulation and economic growth

-Theories of regulation

-The regulatory burden

-Measures of regulation

Competition and growth

Competition is widely recognized as a vital factor contributing to accelerated economic growth and increased consumer welfare due to its stimulating effects on increasing efficiency (Gomaa, 2014; Buccirossi et al, 2011).

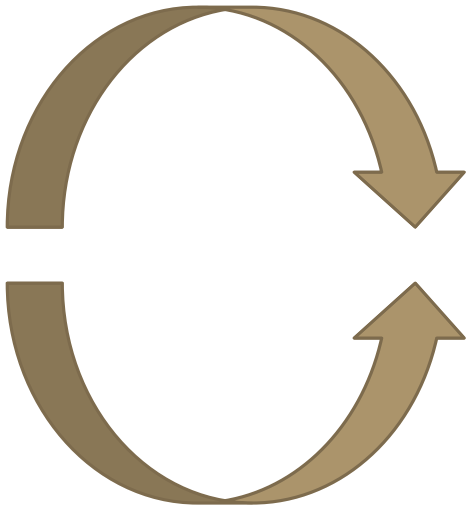
Enhance both productive efficiency:

- minimizing production costs

- providing incentives for the development of new products and production techniques.

However, the contribution of competition to economic growth has been widely debated by economists. Some theories argue that competition constrains innovation, while others maintain the opposite.

Joseph Schumpeter



SNAPSHOT
ECONOMY

HOW TO DISRUPT
THIS CIRCULAR
FLOW

1 – Production of New Goods and Services

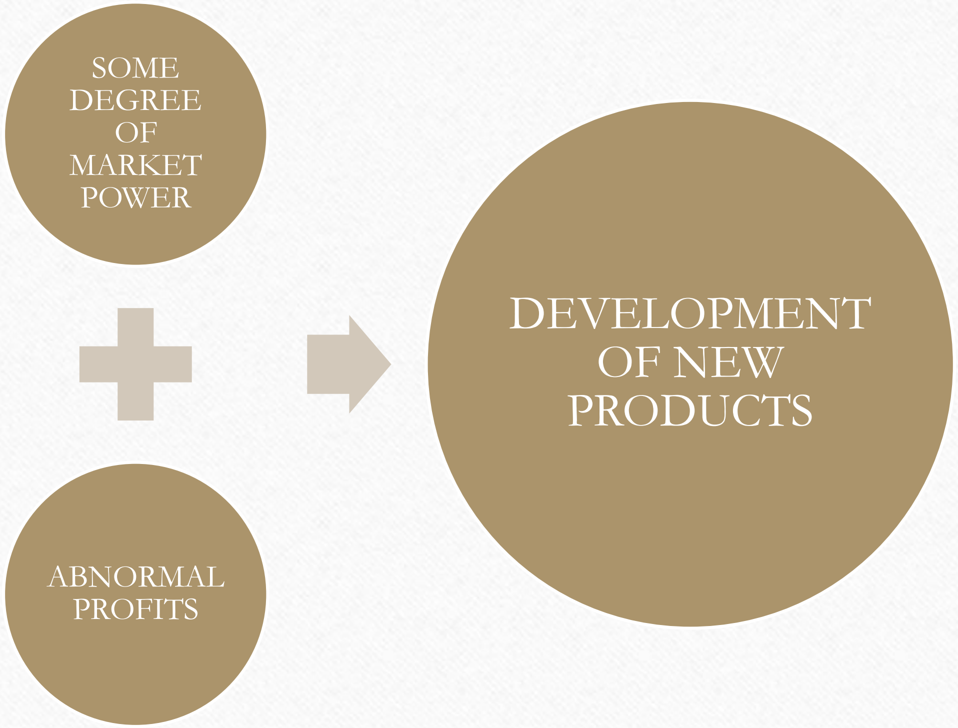
2 – New Methods of Production

3 – Exploitation/Discovery of New Market

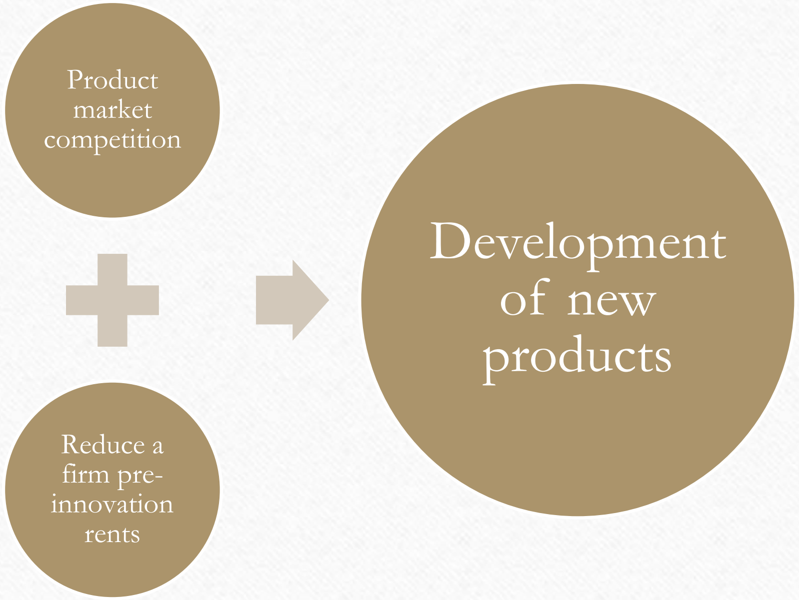
4 – Finding new source of materials (Raw materials)

5 – New Methods of Organization

CREATIVE DESTRUCTION



Counter- arguing Joseph Schumpeter



Aghion et al (2000) highlight that in reality, most innovative activity occurs within industries comprising more than one firm. Crucially, they argue that more product market competition may reduce a firm’s pre-innovation rents by more than it reduces post-innovation rents. In this scenario, an increase in product market competition can stimulate R&D by increasing the incremental profit from innovating, strengthening the motive to innovate in order to escape competition with “neck-and-neck” rivals

Schumpeterian effect of more competition is almost always outweighed by the increased incentive for firms to innovate in order to escape competition

Maximum growth rate is always achieved by allowing the maximum degree of competition

Looking at patent protection in isolation, the study finds that as the level of patent protection weakens, the growth rate always falls.

Regulation and growth

The relationship between regulation and economic growth is a complex one, as regulation is both a precondition for the functioning of markets as well as a commonly cited hindrance for firms to enter new markets, innovate and grow.

A distinction is commonly made

Larger firms

Businesses that have the capacity and interest to innovate their way out of regulation

Businesses who do not have this capacity

Small and medium- sized enterprises (SMEs)

Studies and respective outcomes

Study performed by the OECD

- Increased competition through domestic product market reforms in the EU and the US associated with:
- Static (one-off) and dynamic (continuous) gains in GDP via an improvement in multi-factor productivity (i.e. the combined productivity of labour and capital) (OECD, 2005b)

State control and barriers to Entrepeneurhsip

- Australia – Best practice , least restrictive policy related to size and scope of the public enterprise sector
- Denmark and Ireland – lowest administrative burdens on the start-up of new business
- Uk and Ireland – Lowers barriers to competition

Static gains were projected to arise from better allocation of existing resources and from a take-up of slack in the use of resources.

Dynamic gains, in turn, were expected to arise from greater efforts to innovate and optimize production, and from more rapid diffusion of new technologies.

The effects of regulatory reform enabling more competition on for example innovation and productivity can be diverse. however, and depend on factors such as the technological characteristics of the industries or the distance of a firm or country to the technological frontier

(Rincon-Aznar et al, 2010)	In sectors where firms are technologically similar, firms' potential to innovate and catch up might be greater and increased competition might provide an incentive for firms to innovate in order for incumbents to 'escape' competition
Nicoletti and Scarpetta (2003)	The overall effect of increased competition on the economy is argued to be stronger the higher proportion of technologically similar industries
A number of other studies of the ICT sector	Suggest that entry barriers resulting from regulation have had negative impact on productivity growth in the sector
Ciccone and Papaioannou (2007)	Countries where legal status to operate firms can be obtained more quickly see significantly more entry in industries that experience expansionary global demand and technology shifts

Theories of Regulation

Reasons for government regulation:

- enable effective and transparent competition between firms
- prevention and correction of market failures

Public interest theories

- Assumes regulation serves the interest of **consumers** by **correcting market failures and increasing social welfare.**
- **Austrian theory**

Well intentioned regulation → Mismanagement and/or regulation skews competition and causes problems in the market → Further intervention to correct distortions

Critics of Public Interest Theories (Posner, 1974)

- No **positive correlation** between the **presence of externalities** and **monopolistic market structure and regulation**.
- Austrian theory is unsatisfatory – regulators frequently desire social **undesirable results of regulation** and evidence showing mismanagement by regulatory agencies is weak.

Private interest theories

- Regulators **lack information** preventing them from perfectly elaborate R&R which promotes the public interest.
- **Public choice theory**
  - Politicians are **driven by votes**
  - Regulatory agencies’ employees serve **bureaucrats’ structure**
  - Bureacrats respond favourably to **lobbyist and special interest groups**

Private interest theories

- **Capture Theory**
  - Regulation often ends up serving the regulated firms and not the public.
  - Firms seek to keep new firms from entering the market and prevent price competition

FIRMS
Information advantage

Information which gets the regulators to enforce regulations that protect profits

REGULATORY AUTHORITIES
Rely on information provided by those firms

Private interest theories

- **Chicago theory**
  - Regulation is acquired by the industry and operate in its benefit.
  - Interest groups with enough capacity will exercise political influence.
  - Politicians, driven by votes, honor the demand by interest groups who supply votes and other resources in return.

Critics of Private Interest Theories

- In practice, regulation appears to serve the interest of consumers
- Much regulation, such as environmental and health and safety is opposed by businesses
- It is empirically test private interest theories

Study Results (Djankov et al.)

- **Objetive:** Test the validity of different Theories of Regulation
- **Data:** Regulation of entry of start-up firms in 85 countries
- **Results:** Countries with higher regulation of entry have higher corruption, larger unofficial economies and don't have higher quality of public/private goods
- **Conclusions**: Evidence supports the public choice view but ia inconsistent with Public Interest Theories.

Table 1. Summary of theories of regulation[1]

Theory	Rationale
Public interest theories	Intervention to correct market failures and to increase social welfare.
Austrian theory	Regulation is well intended, but the distortion in the market the intervention creates causes problems which require further interventions. Regulatory spiral.
Private interest theories	Regulators do not have sufficient information regarding costs, demand, quality and other dimensions of firm behaviour. Can therefore only imperfectly, if at all, promote the public interest when regulating firms.
Public choice theory	All individuals are driven by self-interest. Politicians make decisions in favour of businesses in order to maximise their own chances of becoming re-elected.
Capture theory	Regulations often end up serving the regulated firms rather than the public. Regulated firms, which possess an information advantage over the regulatory authorities, get regulators to enforce regulations that protect profits. Regulators get "captured" by the firms they are supposed to be regulating.
Chicago theory	Regulation is acquired by the industry and is designed and operated primarily for its own benefit. Interest groups that can organise themselves less expensively than others will exercise political influence. Politicians honour the demand for regulations by the interest groups who supply votes and other resources in return.

The regulatory burden: direct and indirect costs

- Regulation
  - Direct costs
    - Financial costs
    - Also includes hassle costs (corruption, delays…)
  - Indirect costs
    - Incured in areas or experienced by consumers, government, agencies, ect.
    - Unintented costs

Impacts of regulation on competition

- Indirect effects can affect competition on a national or international level
- OECD guidance (competition is affected by regulation):
  - If it limits the number or range of firms;
  - If limits the ability of firms to compete;
  - If reduces the incentive to compete;
  - If limites the choices and information of the costumers.

Number and range of firms

Regulations affect the number of suppliers in a market

By creating barriers of exit or entry

Entry barriers

Bureaucracy procedures

Access to credit, tax regime…

Elimination of these barriers has a positive influence on productivity growth

Number and range of firms

Van Stel et al (2007): administrative barriers to entry and to exit only play a modest role;

Brant (2004):

- Administrative burden on start ups can potentially have a negative impact on entry rates;
- Lower entry rates and higher survival rates in countries with higher entry and exit costs;

Number and range of firms(continuation)

Braunerhgelm and Eklund (2013):

- Administrative burden reduces new firm formation;
- 10% reduction on administrative tax leads to a 3% increase in entry rates

Firms ability to compete

Regulations that limit competition ability:

- Price control;
- Product or production method specifications;
- Limit to freedom of the firms to advertisse or market their products.

Sometimes firms are not allowed to advertise their products (alchool products, tobacco..)

Firms incentive to compete

Regulations can affect firms incentive to compete in a negative way, for exemple;

- Restriction related to business expansion;
- Self or co-regulatory regimes;
- Allowing cooperation;
- Regulations related to consumers ability or incentive to switch suppliers.

Self or co-regulations can have advantages:

- Enhance regulatory credibility
- Improve regulatory quality;
- Enforcement cost savings

Firms incentive to compete

However there is risk:

- Price coordination;
- Coordination to prevent entry.

These are not always risks, in some industries (energy industry for example) this cooperation can improve production and distribution or even tecnological development.

Innformation avaiable to costumers

Consumer information is essencial for an effective competition, for example:

- Complex payment systems can confuse costumers and by that affect competition;
- Switching costs or complex switching rules can also affect competition.

Labour market regulation

- Labour market regulation can negatively impact competition
- Van Stel et al (2007): labour market regulations have greater impact than administrative regulations in start ups.
- Those considering to start a business seem to be more influenced by factos that come into play once the business has already started.
- The more flexibility the owner has, the more atractive owning a business becomes (employees becoming owners).
- Excess labour regulation reduces productivity growth.

Labour market regulations

However too relaxed labour regulation could affect productivity in a negative way.

By this, it is needed to find a balance.

OECD - Product Market Regulation

- Measures laws and regulation on 18 quantitative indicators
- Done every 5 years (last one was on 2013) though surveys of governments
- 3 areas of regulation - State Control; Barriers to Entrepreneurship; Barriers to Trade and Investment

OECD - Product Market Regulation

http://www.oecd.org/eco/growth/indicatorsofproductmarketregulationhomepage.htm

World Bank - Doing Business

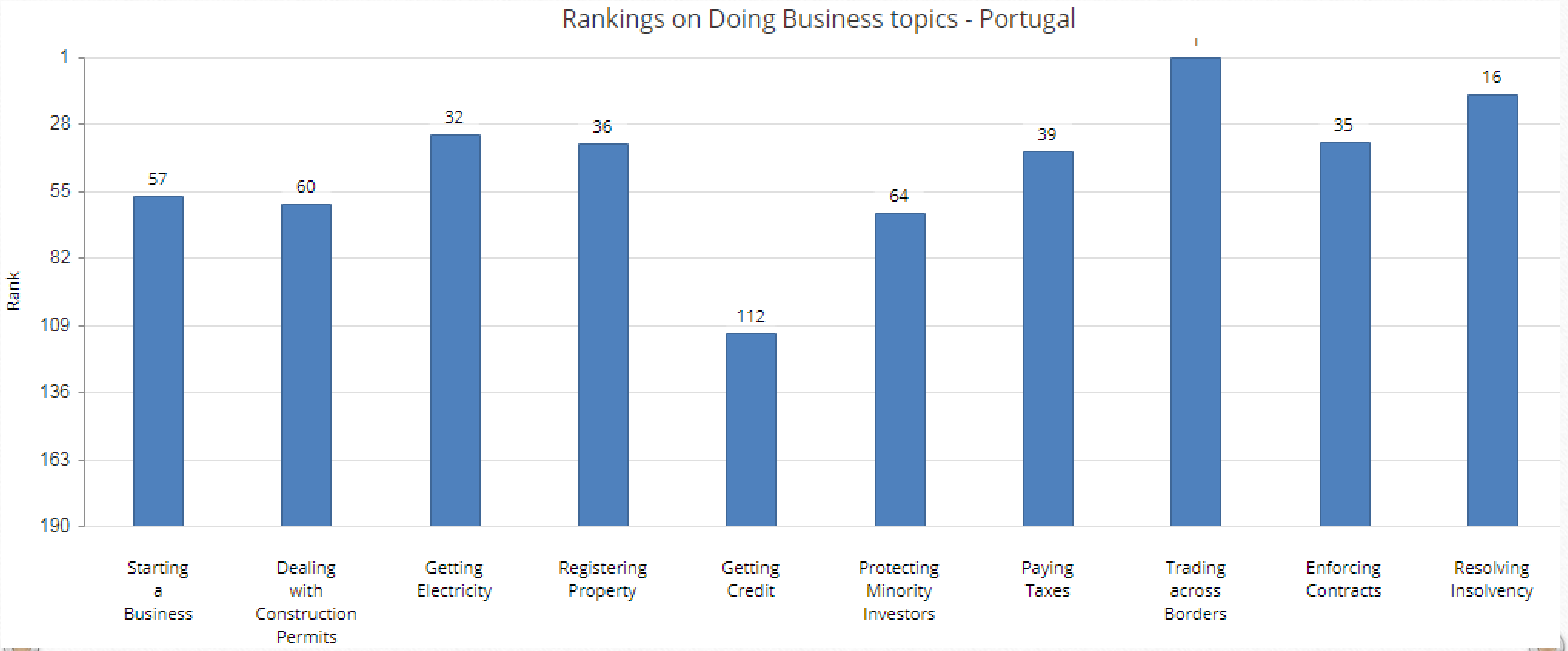
Quantitative measure for regulatory constraints(0 to 100

190 economies today

Good rules, not less regulation

10 areas of the life cycle of businesses with 36 indicators

World Bank's Doing Business - Portugal



Conclusion

Regulation and, importantly, regulatory quality is crucial for the functioning of markets, economic growth and consumer welfare. One strand of theories of regulation, so called public interest theories, pose that regulation is put in place as a response to market failures. The other strand of theories, so called private interest theories, argue that regulation is the result of various powerful interest groups in society who benefit from certain rules and who get their regulatory needs satisfied by politicians and bureaucrats, who act in their own self-interest, aiming for re-election or career advances. Still, no one theory is likely to be able to provide a satisfactory explanation for the existence of regulation in general.

However well intended and justified, it is clear from the literature that rules and regulation can bring significant direct and indirect costs to individuals, businesses and the economy as a whole, not least through negative impacts on competition. From the literature it can be concluded that, while governments' focus on reducing the regulatory burden in terms of administration and direct compliance costs in recent years is positive for businesses, some of the most significant impacts of regulation may indeed take the form of indirect effects such as inhibiting competition in the market and hindering or discouraging the formation of new firms and finally considering indirect impacts when proposing new and amended rules could ultimately contribute to better quality regulation which encourages competition, ultimately boosting economic growth and increasing consumer welfare.