

Under what  
circumstances might  
governments wish to  
regulate markets, and  
how might...



Since the era of post war Britain, the Government's position on how it approaches regulation has been fickle and has gone through several stages and iterations. However, the core underlying theory upon which its regulation policies are based is agreed by many neo-classical economists.

Following the Structure-conduct-performance (SCP) theory. It suggests that the " perfect competition market structure has the most favourable efficiency" and " there is an implicit assumption that competition is good and monopoly is bad" (Lipczynski et al., 2017, p. 710-711). The case for regulation against monopoly is on the grounds of allocative and productive efficiency's. Under a monopoly a firm will operate at the price taking level,  $MC = MR$  at this profit maximising level the firm will not operate at the socially optimal level, a level at which the consumer benefits. " The deadweight loss is a waste in social surplus, by increasing the level of competition in the industry it is possible to increase quantity and reduce the loss" (Begg, 2014, p. 186). Under a monopoly there may also be productive inefficiency's if the firm operating is without competition. The lack of pressure can be attribute to a firm failing to make the most of its factor of inputs and may fail to employ the most cost-effective methods.

Both consumer and producer surplus are low under a monopoly as they have market dominance and are able to set the price due to the lack of competition consequently they have a significant deadweight loss to the consumer. This is further backed up by Lipczynski when he says.

" The existence of a deadweight loss is a corollary of the monopolist preference to produce at an output level at which price exceeds marginal

cost (allocative inefficiency). The size is also increased if the deadweight loss is increased if the monopolist is also inefficient in production.” (Lipczynski et al., 2017, p. 712).

It is for these fundamentals that governments feel the need to intervene in the market, to correct the market failure caused by the abuse of market power of monopolies, to a level which the consumer benefits. The governments ideal aim is a situation where the social marginal cost = social marginal benefit in the long run void of market dominance, asymmetric information, price discrimination, high prices and with choice.

A natural monopoly however is one where the best outcome for the consumer is a monopoly due to their decreasing long run marginal and average costs over the whole range of the market with increasing output. When starting to look at this market structure you have a situation that any reform by the government to increase competition would lead to a “wasteful duplication of infrastructure and delivery systems” (Lipczynski et al., 2017, p. 713), and wouldn’t benefit consumers. Therefore, governments regulate these markets differently they use a form of conduct regulation that creates a “synthesised regulator by drawing comparisons between utilities and forcing efficiencies on them” (FT, 2017) a somewhat quasi-competitive solution where there is an allocative efficiency gain.

This type of regulation can be seen though the UK in industries where “the cost of the infrastructure means that each utility’s customer base is all but determined by geography” (FT, 2017), such as water, gas and electricity.

The monopoly is defined by the geographical area and consumers have no

other choice in where they get the utility from for example, Yorkshire water which services the Yorkshire area as well as parts of Lincolnshire and parts of Derbyshire. It was believed that left to the free market the water firms could charge above the marginal social benefit level forcing consumers to buy water at an inflated price as homes will not go without. Therefore, the government stepped in assuming control of the industry.

“ It is difficult, if not impossible to combine the citizens’ rights and interests and the private enterprise’s interests, because the private enterprise aims at its natural and justified objective, the biggest possible profit.” (Juuti, 2007, p. 241)

The era of regulation, the 1945 general election proved a pivotal tipping point for regulation, the country didn’t want to return to a pre-war depression and so chose a Labour party that was a ‘ Socialist Party, and proud of it’ and “ would take control of the economy and in particular of the manufacturing industry” (Brown, 2001). This led to significant industries like Rail, Iron and Steel and telecoms being assumed by the government with highly strung planning controls backed by the BoE. “ Governments around the world increased the scope and magnitude of their activities, taking on a variety of tasks that the private sector previously had performed” (Goodman & Loveman, 1991)

The creation of monopolies owned by the government is done to correct the market failures of a monopoly, namely abuse of power, asymmetric information to increase allocative efficiency whilst still maintaining the efficiencies of a monopoly. The idea of eliminating waste. This type of reform

on paper works well in pursuit of social objectives, it is however difficult to achieve. One of the main issues when government bodies prohibit competition is a lack of competition. We know that a perfectly-competitive market the rigors of competition drives efficiency, with no threats from the outside, firms leave themselves exposed to X-inefficiency and a loss of productive efficiencies. “ After the initial euphoria of nationalisation, it wasn’t long before doubts began to emerge. The state industries were smothered by bureaucracy” and “ Their bolder ideas were often subsumed in the delicate balance between principle and pragmatism” (Brown, 2001). This lead to the second era of regulation, a U-turn on the previous two decades of policy and intervention.

The Thatcher era defined by privatisation, a different approach to regulation. Thatcher’s revolution of “ deregulation and political transformation” Bolick (1995). The idea that nationalism had not and could not correct market failure due to its nationalized industries being bloated and inefficient, demanding ever-heavier public subsidies because of declining productivity” (Bolick, 1995 p529). By means of sweeping nationalisation the under lying social effects of privatisation began to shine through. Privatisation is essentially the opposite of nationalisation it is the “ transfer and sale of state owned assets from the public to the private sector” (Lipczynski et al., 2013, p. 702). Vickers and Yarrow suggest the objectives for doing so are;

1. improving efficiency;
2. reducing the public sector borrowing requirement;
3. easing problems of public sector pay determination;
4. reducing government involvement in enterprise decision making;

5. widening ownership of economic assets;
6. encouraging employee ownership of shares in their companies; and
7. redistributing income and wealth.

Privatisation was the government's attempt to rectify the downfalls of nationalisation. Privatisation increases competition within the market, what this effectively does is increases the productive efficiencies within the market as firms are battling for profits and market share, within significant improvements made in decreasing X-inefficiency as firms search to reduce costs. Changes in the levels of efficiencies could be furthered if “ accompanied by a change in market structure” (Lipczynski et al., 2013, p. 704), if the breakup of assets were changed into the competing firms there then maybe a situation of intense cost-saving measures by newly formed incumbent firms to gain market share and dominance. Giving consumers greater choice lower price and a better product, it undoes the inefficiencies of public sector ownership by introducing private sector strategy where you also get pressure above from shareholders to increase profits another motive for reducing waste and ultimately cost.

This form of regulation has the potential to work against consumers. If for instance the newly privatised firm uses its monopoly power in pursuit of shareholder value there is a potential loss to the consumer in the form of higher prices and market exploitation. The sales of state owned assets, there is a transaction involved in which the government will receive payment. There is an argument of short-termism with the sales of the assets. Selling the assets could work wonders by “ reduce(ing) debt, finance infrastructure, boost economic efficiency. But governments often barely grasp the value

locked up in them” (Economist, 2014). The independents John McDonnell thinks that “ Government sold off Royal Mail for a fraction of its value”. There is also a possibility that a gap could appear in the public finances in the future years when no saleable assets remain.

This type of regulation does however relieve governments from potentially crippling debt. If nationalised industries fail to make profit the burden must be picked up by the government in the form of subsidies. What this entails is huge borrowing costs in which seen at the end of the regulation era, “ public sector corporations had accumulated debts of £27 billion (£55 billion measured in 1990 pounds sterling)” (Bolick, 1995).

### Bibliography

- Begg, D. (2014) *Economics* . 11th ed. London [etc.], McGraw-Hill Education.
- Brown, D. (2001) 1945-51: *Labour and the creation of the welfare state* [Internet]. Available from: [Accessed 8 November 2018].
- Bolick, C. (1995) *Thatcher’s Revolution: Deregulation and Political Transformation* , 12 Yale J. on Reg . Available from: <http://digitalcommons.law.yale.edu/yjreg/vol12/iss2/6>[Accessed 8 November 2018].
- Economist (2014) Setting out the store [Internet]. Available from: [Accessed 12 November 2018].
- FT (2017) The UK water regime calls out for change | Financial Times [Internet]. Available from: [Accessed 8 November 2018].

- Goodman, J. & Loveman, G. (1991) Does Privatization Serve the Public Interest? [Internet]. Available from: [Accessed 12 November 2018].
- Juuti, P. (2007) *Environmental history of water* . London, IWA Publ.
- Lipczynski, J., Wilson, J. & Goddard, J. (2013) *Industrial Organization*. Harlow, Pearson Education UK.
- Lipczynski, J., Wilson, J. & Goddard, J. (2017) *Industrial Organization*. Harlow, Pearson Education UK.
- McDonnell, J. (2017). The privatisation of our public services has been national failure. [online] The Independent. Available at: <https://www.independent.co.uk/voices/privatisation-failure-energy-water-railways-public-services-take-back-control-labour-john-mcdonnell-a7775216.html> [Accessed 12 Nov. 2018].
- Vickers, J. and Yarrow, G., (1988), “ Privatisation: An Economic Analysis”, MIT Press.