

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

Cancels & replaces the same document of 05 December 2014

INSTITUTIONAL DESIGN OF COMPETITION AUTHORITIES

-- Note by Allan Fels and Henry Ergas --

17-18 December 2014

This paper by Professor Allan Fels (Former Chair of the Australian Competition and Consumer Commission) and Henry Ergas (Professor, University of Wollongong, Australia) was submitted as background material for the Roundtable on Changes in Institutional Design of Competition Authorities which will take place at the 122nd meeting of the OECD Competition Committee on 17-18 December 2014.

The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or of the governments of its member countries.

More documents related to this discussion can be found at <http://www.oecd.org/daf/competition/changes-incompetition-institutional-design.htm>.

JT03368719

Complete document available on OLIS in its original format

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

TABLE OF CONTENTS

1. Introduction	3
2. The Interrelation of Competition and Consumer Policy.....	5
3. Emerging Challenges.....	7
3.1 Developments in understanding of consumer behaviour.....	7
3.2 Expanding role of markets.....	12
3.3 Conclusions	17
4. Institutional design and institutional challenges.....	17
4.1 Benefits of integration	17
4.2 Costs of integration.....	20
4.3 Conclusions on institutional design issues	22
5. Regulation and Competition.....	23
5.1 Regulation.....	24
5.2 The implications for institutional design	29
5.3 Implications	31
6. Conclusions	32

INSTITUTIONAL DESIGN OF COMPETITION AUTHORITIES

*Note by Allan Fels and Henry Ergas**

1. Introduction

1. That consumer protection policy, economic regulation and competition policy are largely interdependent instruments of economic policy, each aimed at serving a common purpose of enhancing the efficiency with which markets work, has been stated on many occasions and is widely accepted. It is also widely recognised that there can be, and at times are, tensions between those policies. Moreover, as a practical matter, there are differences in how those policies work, and in the nature of the process by which decisions are taken and implemented. Recognition of these interdependencies and of the differences leads naturally to a consideration of the institutional arrangements for these policies and specifically, of how they should be coordinated.

2. This paper explores these themes, setting out the main issues as a basis for discussion without seeking to be comprehensive in their treatment. It makes the following main points:

- Competition policy, consumer policy and economic regulation share a common purpose while relying on differing instruments to achieve that purpose. Usually, they should reinforce one another; however, it is not uncommon for them to clash, for example, when consumer policy or economic regulation are used in ways that unnecessarily restrict competition. Also, the introduction of competition may occur without sufficient regard to consequential consumer protection or economic regulatory issues;
- While these issues about the balance and coordination between competition policy on the one hand and consumer policy and economic regulation on the other are hardly new, they have attracted increased attention in recent years for a number of reasons, including
 - Advances in behavioural economics, which have highlighted their cognitive limitations affecting consumer behaviour (section 3.1); and
 - The extension of competition to new and difficult areas (section 3.2), including the professions and markets for public utilities and services.

3. While these developments do not alter the appropriate role of, or respective balance between, competition policy and consumer policy, they do strengthen the case for a coordinated approach to these policy areas;

* This paper was drafted as a Background Note by Henry Ergas (Professor, University of Wollongong, Australia) and Professor Allan Fels (Former Chair of the Australian Competition and Consumer Commission).

- This naturally raises the issue of how that coordination is best achieved (section 4):
 - While there can be benefits to integrating responsibility for the enforcement of competition policy, consumer policy and economic regulation within a single institution, the reality is that there will always be limits to the extent and effectiveness of that integration;
 - Thus, the nature of these tasks associated with these policy areas differs in important respects; moreover, consumer policy and economic regulation inherently involve a very wide range of instruments, many of which are sector- or industry-specific, and which are not readily brought under a single umbrella;
 - As a result, whatever view is taken of the appropriate degree, if any, of institutional integration of competition and consumer law enforcement and economic regulation, an important goal should be as a minimum to ensure that the competition policy authority has the expertise required to monitor developments in the design and administration of consumer policy and economic regulation and to act as an advocate for competition in the consumer policy and economic regulatory process; similarly, consumer and economic regulation agencies should arguably have the skills to monitor and assess competition issues.
 - It is also likely to be important to ensure that there is within government an entity that has whole of government oversight of consumer protection and economic regulation, and that exercises that oversight in a manner mindful of competition concerns;
 - Periodic surveys of particular instruments - such as occupational licensing, or restrictions on advertising or regulation regarding access to “essential facilities” - aimed at reviewing whether they were consistent with efficient competition, may play a useful and important role in giving structure to this coordination process.

4. We do not seek, in this paper, to nest the relevant issues in a unified conceptual framework. Rather, we proceed by examining the interaction of competition policy first with consumer policy and then with economic regulation. In each case, we seek to explain the nature of the relevant policy area; and on that basis, analyse whether there are ‘economies of scope’ between the instruments and processes it involves and those of competition policy. It is in the light of those economies (and diseconomies) of scope that we consider the institutional linkages that might be defined between each of these areas and competition policy.

5. To summarise our findings, while the appropriate institutional arrangements will also depend on a host of country-specific factors, we see closer linkages between competition policy and consumer policy than between competition policy and economic regulation. We are also concerned that combining competition policy and economic regulation may weaken the ability and incentive of the competition authority to act as an advocate for competition in regulated industries, and might imbue the competition authority with a potentially desirable ‘command and control’ culture. For that reason and others, we conclude the tasks of competition enforcement on the one hand, and direct economic regulation on the other, should be vested in separate entities.

2. The Interrelation of Competition and Consumer Policy

6. As a general matter, competition policy aims at protecting, and where appropriate and efficient extending, the range of choices available to consumers. At the same time, consumer policy seeks to protect, and where appropriate enhance, the quality of that choice, and to ensure that consumers can exercise choice effectively and with confidence in the fairness and integrity of market processes.¹

7. That each of these policies largely promotes the goals of the other is readily exemplified.

8. Thus, as a general matter, the risk of displacement that bears on firms in effectively competitive markets creates incentives for those firms to develop and protect a reputation for being good quality suppliers, since this allows them to secure repeat business and reducing marketing costs. This reduces the burden that would otherwise fall on consumer policy in terms of enforcing product and service standards, as firms will have incentives of their own to meet and exceed customer expectations. In that sense, ensuring that a market is effectively competitive can help meet one of the central concerns of consumer policy.²

9. Equally, firms that operate in effectively competitive markets, and hence can hope to attract customers away from rivals, will have incentives to reduce those customers' switching costs, both by informing them of the gains from shifting and by helping them to bear any once-off costs shifting involves. The result of firms investing in reducing the switching costs incurred by each other's customers can be both to make competition more vigorous and to diminish the need for consumer policy interventions aimed at reducing switching costs. Here too, ensuring a competitive supply structure may be an effective way of dealing with what, in some circumstances, would otherwise be a consumer policy problem - that is, switching costs.

10. The same applies to many consumer policy interventions. For example, policies that ensure that advertising and product descriptions are honest and reasonably informative, that contract terms and the obligations they involve are understandable and not disproportionate, and that consumers can reasonably expect products to be safe and fit-for-purpose, will both make consumer choice a more effective discipline (thus directly strengthening competition) and will force firms to compete on the merits (rather than on the basis of fraudulent or misleading claims or of unfair contract terms).³ Equally, product standards, by facilitating comparisons between products, increasing the ease with which products from one supplier can be replaced by products from another, and concentrating competition on performance rather than on features that are inessential to it, can directly improve both consumer choice and the competitive process.

11. In short, each of these policy instruments can be used to advance the goals also pursued by the other: competition policy, by keeping markets effectively competitive, can reduce the work that needs to be done by consumer policy; consumer policy, by enhancing the ability of consumers to exercise choice, can help make markets more effectively competitive and force firms to compete on the merits, thereby supporting the ends of competition policy.

¹ See Muris, T. (2002), 'The interface of competition and consumer protection', Prepared remarks at the Fordham Corporate Law Institute's 29th Annual Conference on International Antitrust Law and Policy; and Sylvan, L. (2004), 'Activating competition: The consumer-competition interface', 12 *Competition and Consumer Law Journal*.

² OECD (2004), *Identifying and tackling dysfunctional markets*, p. 3.

³ European Commission (2004), 'Identifying and tackling dysfunctional markets', Note submitted to OECD for discussion at the joint meeting of the Competition Committee and the Committee on Consumer Policy, 13 October 2004, at pp. 2-3

12. At the same time, each of these instruments can create challenges for the other.

13. For example, opening a previously highly regulated market to competition may well raise new issues for consumer protection:

- Many OECD countries faced new consumer protection issues as a result of the liberalisation of financial markets, which, however beneficial it may have been, exposed consumers to new risks and difficulties.⁴
- Equally, the introduction of competition into some public utility markets (such as electricity and telecommunications) has created challenges in terms of regulation of service quality and of issues such as the management of churn, of customer complaints and of disconnection for non-payment.⁵ It has also raised questions about the ability of consumers to understand what are often complex pricing schemes and exercise choice between them.
- Finally, liberalisation of professional services poses complex questions about balancing competitive pressures (for example, in terms of pricing and marketing, including advertising) with the protection of consumers in situations characterised by potentially large information asymmetries and substantial error costs.

14. Moreover, when a market becomes more exposed to competition than it was previously (say, because of the removal of trade barriers), the incentives of market participants may change in ways that raise consumer protection concerns:

- For example, incumbent firms, faced with customers that are more mobile, may seek ways of locking customers in, including by building termination penalties into customer contracts. While those arrangements can be fully reasonable in some instances, they may raise both competition and consumer protection concerns in others.
- Additionally, to the extent to which an inefficient dominant firm realises that it will lose market share and perhaps even be entirely displaced, it may have less of an incentive to invest in long-term assets such as reputation, and therefore be more willing to take advantage of any customers it has that are locked in or otherwise vulnerable.
- Moreover, where the dominant firm was previously a monopolist operating in a highly regulated environment, it may well have very little experience with consumer-oriented marketing. Especially in the initial stages of competition, where the incumbent is seeking to slow and deflect competitive entry and clear consumer protection measures have not yet been put in place, this can result in a temptation to resort to tactics that are not fully consistent with accepted business practices.

⁴ These challenges are discussed by Australia's Secretary to the Treasury at Henry. K. (2007), *Connecting consumers and the economy: The big picture*, Closing address to the National Consumer Congress, at pp. 7-8, available at http://www.treasury.gov.au/ncc/content/download/Presentations/Transcripts/connecting_consumers_and_the_economy.rtf

⁵ Some of these problems are discussed in Waddams, C. *Reality bites - The problems of choice* and other papers following, in OECD (2006) *Roundtable on demand-side economics for consumer policy: Summary report*.

- At the same time, the liberalised market may attract - fly by night operators, whose unscrupulous practices undermine consumer confidence in the market as a whole, reduce consumers' willingness to rely on information firms in that market provide, and thereby erode the incentives for all firms to act honestly. Moreover, those firms that do act honestly will be forced to bear additional costs in so doing (as they seek to signal to consumers the higher quality of the information they provide), increasing prices and reducing both consumer and producer surplus.⁶

15. In the same way, consumer protection policies, however well-intentioned they may be, can have adverse consequences for competition, with the ultimate outcomes being contrary to the goals that both consumer and competition policy should seek. Classic cases include prohibitions on comparative advertising, mandatory product standards that exclude low-cost entrants and products, and transparency and posted price requirements that facilitate collusion.⁷

16. In summary, the relation between competition policy on the one hand, and consumer policy on the other, is relatively complex. In most instances, the one supports the other; but there are cases where, in practice, they are in tension or conflict.

3. Emerging Challenges

17. The issues associated the appropriate mix of competition and consumer policy have recently attracted increased attention partly as a result of developments in our understanding of consumer behaviour (discussed below at 3.1) and partly as a result of changes in the extent and functioning of markets (discussed at 3.2).

3.1 *Developments in understanding of consumer behaviour*

18. The economics of consumer protection have received a considerable boost in recent years as a result of advances in - behavioural economics. Those advances have stressed the impact that cognitive limitations have on consumer choice. The area of behavioural economics is very large indeed, and it is not possible or desirable to survey that area at all systematically here. However, a consideration of some important aspects of the results found in the literature on behavioural economics is helpful in illustrating how competition and consumer policy considerations interact.

19. Thus, economists have long recognised that information is costly and imperfect, so that consumers may not be able to allocate their budgets in ways that always secure the products they prefer, at the lowest prices available and hence from the most efficient supplier. That standard model of rational choice under conditions of costly and imperfect information remains an extremely powerful tool for understanding consumer and competition policy issues, and framing appropriate policy responses. What - behavioural economics adds, relative to that model, is an emphasis on what appear to be departures from rational decision-making, at least as that is defined in conventional decision analysis. Those deviations from - rational actor conduct could cause consumers to take decisions that appear inconsistent with welfare maximisation even when markets are reasonably competitive and search and information costs are not especially high. Indeed, some of these results suggest that increased competition, to the extent to which it

⁶ In the extreme case, this results in the so-called lemons' problem discussed in Akerlof, G. (1970), "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism". *Quarterly Journal of Economics* 84 (3): 488-500

⁷ A case study of inappropriate interventions can be found in the legal services market. See OECD (2004), Identifying and tackling dysfunctional markets at pp. 6-10.

leads to a proliferation of choices available to consumers, could yield only small, or in some instances even negative, welfare gains.⁸

20. While many of these findings are robust in experimental terms⁹, their interpretation is understandably controversial.¹⁰ Even more importantly, it is by no means clear that they amount to a case for a more interventionist - paternalist - stance in respect of consumer protection policy generally. Nor is it clear that these findings diminish the value of, or weight that should be given to, protecting (and where appropriate, promoting) competition. In effect, a move away from primary reliance on competitive markets as the means of empowering consumers and/or to a more interventionist approach to consumer policy could involve substantial costs. These include the costs of the regulatory errors that are inevitable under a paternalist approach, especially one that involves limiting consumer choice.

21. Moreover, those costs need to be weighed against the fact that if cognitive limitations lead to potential gains from trade not being realised, then firms themselves may have incentives to seek ways of achieving those gains. There may, in other words, be market solutions to some of the welfare losses that would otherwise arise from constraints on individual rationality. Put slightly differently, competition and market forces may themselves be important ways of addressing concerns about the efficacy with which consumers take complex choices, because firms in competitive markets have incentives to offer consumers solutions that allow potential gains from trade to be more fully realised.

22. To take but one case, where the basic difficulty lies in frailty of will - for instance, with respect to commitments to save products can develop that seek to at least reduce that difficulty through various forms of pre-commitment. For example, a successful voluntary superannuation scheme in Australia, offered by a number of major employers to new employees, relies on the lower likelihood of consumers opting out from a default position than opting in - that is, on an endowment effect. If employees do not choose to opt out, the scheme commits them to paying a higher than mandatory rate of superannuation contribution.

23. Equally, - confusopoly - apparently deliberate attempts by firms to offer consumers choices that are confusing, for example, in terms of having prices that are difficult to compare with other offers in the market - may well be a serious problem for some consumers. However, just as some firms can seek to gain customers by making offers difficult to analyse or compare, other may compete by cutting through the confusion and offering simple pricing that consumers find attractive. Attempts by incumbents at “muddying the waters” create incentives for one or more suppliers to differentiate themselves by introducing a price structure that is simpler and hence more attractive. Experience highlights how powerful this mechanism can be.

24. Thus, in many countries, the initial stages of telecommunications deregulation saw a proliferation of complex pricing plans, especially for long distance service, making it very difficult for consumers to evaluate value for money. More recently, however, there has been a trend to simpler, clearer pricing, with “all you can eat” schemes bundled across multiple services coming into widespread use.

⁸ See Ergas, H (2007), Policy Implications of behavioural economics: the case of consumer protection, *Productivity Commission Round Table on Behavioral Economics*, Melbourne, Australia.

⁹ See generally Guala, F. (2005) *The Methodology of Experimental Economics*. Cambridge University Press.

¹⁰ For example, Plott and Zeiller, Exchange Asymmetries Incorrectly Interpreted as Evidence of Endowment Effect Theory and Prospect Theory?, *American Economic Review*, September 2007, and Plott and Zeiller, - The Willingness to Pay-Willingness to Accept Gap, the Endowment Effect, Subject Misconceptions, and Experimental Procedures for Eliciting Valuation, *American Economic Review*, June 2005, suggest that results that seem consistent with behavioural models of choice may also be fully capable of being explained by conventional rational choice models.

25. Equally, in aviation, competition between traditional full service airlines involved complex price discrimination, structured around restrictions on the date, day and time of travel, including through minimum stay and Saturday night requirements. The relatively high margins this permitted created opportunities for competitive entry, with Value Based Airlines (such as SouthWest in the United States, RyanAir in Europe and Virgin Blue in Australia) introducing a far simpler pricing scheme, in which there are no minimum stay restrictions and prices are set mainly according to time of purchase. Faced with this form of competition, full service airlines have responded by greatly simplifying their own pricing, facilitating effective consumer choice.

26. In retailing too, sales and other specials serve as useful forms of price discrimination, but also increase consumer search costs (indeed, that is an important part of how the price discrimination works). Walmart in the United States broke this pattern and adopted an “Everyday Low Prices” model, in which prices are set on the basis of low, but stable, mark-ups. That model has been widely taken up internationally, and studies find that those firms adopting this model have seen a significant increase in their market share and generally in their relative profitability, while competition in retailing has become more intense.¹¹

27. The crucial point in all of these cases is that decision-making technologies are not merely the work of consumers - they also depend on the action of firms. Profit-maximising firms have incentives to exploit otherwise foregone gains from trade, including by improving the ability of consumers to act on their preferences. These incentives are likely to be strongest for the most efficient firms, as they have more to gain by reducing search costs. As a result, these firms can and in many cases do undertake actions that internalise, and thereby offset, the costs (in terms of foregone gains from trade) that would otherwise arise from cognitive constraints on consumer decision-making. This aspect of competitive dynamics is typically absent both from the laboratory settings in which much behavioural economics research has been undertaken.¹²

28. The response of firms to cognitive limitations affecting consumers is also largely absent from models of markets characterised by “shrouded attributes” - that is, situations in which some consumers, but not others, are unaware of hidden costs associated with certain products (such as cartridges for ink-jet printers and broadband charges in hotel rooms).¹³ In these situations, it may not be profitable for producers to disclose the hidden costs, so long as sophisticated consumers have the ability to avoid them while still buying the products, which are cheaper because of the “subsidy” naïve consumers provide.

¹¹ Hoch, Stephen J. and Dreze, Xavier and Purk, Mary E. (Oct 1994), *EDLP, Hi-Lo, and Margin Arithmetic*, *Journal of Marketing*, 58; Lal, Rajiv and Rao, Ram (1997), *Supermarket Competition: The Case of Every Day Low Pricing*, *Marketing Science*, 16 (1); Ortmeyer, Gwen and Quelch, John A. and Salmon, Walter (Fall 1991), *Restoring Credibility to Retail Pricing*, *Sloan Management Review*, 55 (12); and Tang, Christopher S. and Bell, David R. and Ho, Teck-Hua (Winter 2001) *Store Choice and Shopping Behaviour: How Price Format Works*, *California Management Review*, 43 (2).

¹² One of the few attempts to mimic the effects of this kind of innovation is the paper by Chu, Y. P and R. L. Chu (1990) - *The Subsistence of Preference Reversals in Simplified and Market like Experimental Settings* *The American Economic Review*, vol 80, pp. 902-911. The authors introduce arbitrage into a money-pump game. Interestingly, they find that while subjects display preference reversals absent arbitrage, once they are exposed to arbitrage their preferences converge towards consistency with - rational actor norms.

¹³ See Ellison, G. (2005) - *A Model of Add-On Pricing* *Quarterly Journal of Economics*, vol. 120, pp. 585-638 and Gabaix, X. and D. Laibson (2006) - *Shrouded Attributes, Consumer Myopia and Information Suppression in Competitive Markets* *Quarterly Journal of Economics*, vol. 121, pp. 505-540.

29. While these “shrouded attributes” models are elegant and at times suggestive,¹⁴ they rest on strong assumptions. More specifically, as well as the conventional - and demanding - individual rationality assumptions required to solve games of this type, there is the assumption that no firm would gain a significant first-mover advantage by deviating from the “hidden costs” strategy.¹⁵ This assumption seems quite inconsistent with the experience summarised above, where firms have derived significant innovators’ rents by being the first to exploit previously unrealised gains from trade.¹⁶

30. To suggest that market forces can, at least in part, correct some of the biases and limitations associated with consumer choice is not to say that businesses do not seek to exploit those very biases and limitations. Indeed, the opposite is likely to be case, most obviously in consumer marketing and advertising, which relies on an increasingly sophisticated understanding of how consumers choose. This makes it important for regulators to take account of those biases and limitations in assessing consumer marketing and advertising, especially in respect of products with direct consequences for health and safety. However, the point remains that to the extent to which cognitive biases and limitations prevent consumers from actually choosing in line with their preferences - whatever those preferences may be, and regardless of how well founded they are - one of the ways in which firms can seek to secure a competitive advantage (and profit from the fuller realisation of gains from trade) will be by assisting consumers to improve on the choices they make.

31. In short, while the results of the behavioural economics may suggest a need for a consumer policy response - in the direction of greater paternalism - it may be that at least some of the issues it raises are best addressed through the competitive process: that is, by ensuring competitive forces are effective.

32. While it is important to recognise these limits of the policy inferences properly drawn from findings in behavioural economics, it would be a mistake to suggest that market incentives will cure all cognitive limitations.

33. This has long been recognised by economists with respect to that markets that are distorted by misrepresentation, which in its extreme forms amounts to fraud. As with all information asymmetries, misrepresentation can give rise to allocative inefficiencies (as trades will not reflect accurate valuations of the goods being traded), as well as to productive inefficiencies (because consumer search costs are increased, production may be allocated to less rather than more efficient firms, and firms may waste resources either in lying or in trying to establish a reputation for telling the truth). Of course, in the extreme (and even in conventional models of rational choice), bad information drives out good, no firm has the ability or incentive to disclose truthfully, and the market disappears.¹⁷

¹⁴ See for example, the application of such a model to residential mortgages in Campbell, J. Y. (2006) - Household Finance *The Journal of Finance*, vol. 61, pp. 1553-1603.

¹⁵ Campbell, for example, assumes that firms have no form of intellectual property protection, or that that protection is so weak that there are no innovator’s rents. Additionally, this type of model tends to be highly sensitive to the precise population shares of sophisticated and naïve consumers, to the willingness to pay of these respective groups of consumers and to search costs.

¹⁶ Interestingly, economists very often assume that firms cannot make durable unilateral gains by deviating from a coordinated pricing strategy because pricing strategies are readily copied. (This underpins the concept of a quick response equilibrium, such as that embodied in the kinked demand curve.) In commercial reality, however, devising and implementing pricing strategies is often extremely complicated, and involves changes in systems, in training and billing, accounting and auditing arrangements. As a result, major changes in price structures are often very difficult to copy, and especially to copy well and quickly.

¹⁷ This is the extreme case of adverse selection, in which the market collapses, so that all the potential gains from trade are lost. See Akerlof, G. (1970) - The Market for Lemons: Quality Uncertainty and the Market

34. The same issues about the efficacy of the self-remedying properties of markets can arise, albeit likely in significantly less extreme form, in some of the cases that have been discussed in the consumer policy literature arising from behavioural economics.

35. For example, even when market solutions do emerge to problems such as “confusopoly” or to the pricing of “shrouded attributes”, those solutions may be directed at the more sophisticated consumers (who in any event would have likely suffered the least harm), leaving other consumers still exposed.

36. Indeed, it could be argued that the rise of the Internet as a marketing channel has aggravated the problem of vulnerable consumers. In effect, Internet marketing channels provide firms with considerable scope to differentiate their offers as between customer segments, and most obviously and immediately, as between consumers who are frequent and confident users of the Internet and those who are not. This reduces the extent to which sophisticated consumers “price protect” those consumers who are unsophisticated. While this problem may be merely transitory for some classes of consumers - who over time will become more adept at using the Internet and hence will benefit from the marketing features it provides - they will persist for others, such as the intellectually disabled, the very elderly and (at least in countries such as Australia) important parts of the indigenous population. The policy issue this raises is whether those more vulnerable consumers are best protected through the general instruments of consumer policy, or by more targeted interventions.

37. Moreover, for some of cognitive limitations highlighted in the behavioural research, market solutions may simply not emerge. Addiction goods are potentially a case in point, as consumers, prior to addiction, may not value non-addictive variants sufficiently to allow them to drive more harmful varieties out of the market.¹⁸ Here too, the greatest risks are likely to fall on vulnerable consumers, such as young people who are vulnerable to the lure of advertisements for cigarettes, alcohol and other potentially addictive goods.

38. That said, care needs to be taken, in protecting those consumers who are most vulnerable and/or poorly informed, not to unduly undermine the rewards to those consumers who invest in information gathering.

39. It is true that there are cases where the nature of information as a pure public good means that duplicated search amounts to nothing but waste¹⁹; but there are also many cases where private investment in information is socially valuable, because it helps guide the price discovery process to ever changing fundamental values. In these latter instances, efforts at improving the position of less-informed consumers can reduce the return other consumers make by investing in information, and hence erode the quality of price discovery and welfare overall.

40. This trade-off has been extensively studied in the context of consumer protection issues in securities markets; suffice it to say most economists would place considerable weight on the need to ensure disclosure requirements do not eliminate incentives for costly information acquisition, while still

Mechanism, *Quarterly Journal of Economics*, vol. 84, pp. 488-500 and Hillier, B (1997) *The Economics of Asymmetric Information*. St. Martins' Press, Inc., New York, N.Y., pp. 46-49. The other way of stating matters is to note that complete distrust is a self-enforcing equilibrium: see for example, Gambetta, D. (1998) - Concatenations of Mechanisms in Hedstrom, P. and R. Swedberg (1998) *Social Mechanisms*, Cambridge University Press, Cambridge, UK, pp. 102-124.

¹⁸ Although for a contrary view with respect to narcotics, see O'Flaherty, Brendan (2005) *City Economics*, Harvard University Press, Cambridge, Mass., at Chapter 17

¹⁹ See Barzel, Y. (1982) “Measurement costs and the organisation of markets” *Journal of Law and Economics*, vol. 25, pp. 27-48 discusses these instances but concludes that when the relevant conditions apply, producers will take measures to avoid wasteful duplication of search.

encouraging widespread participation in the relevant markets.²⁰ This does not mean that vulnerable consumers should not be protected; rather, it means that the protection should be designed in a way that avoids unnecessary harm to the incentives that those consumers who are able to invest in information face to do so.

41. In short, there is a need for caution in drawing from the findings of behavioural economics generalised inferences about the stance of consumer and competition policies, all the more so given the fact that regulators too, suffer from cognitive limitations, imperfect information and other constraints on decision-making. Moreover, there will generally remain an issue about which instruments are most appropriate for dealing with the market imperfections arising from cognitive limitations on consumers' ability to make complex choices.

42. This is important because the findings of behavioural economics do seem of obvious relevance to the *design* of consumer policy interventions, if not to the determination of the optimal extent of those interventions.²¹

43. Behavioural economics may, in other words, be even more valuable in helping shape *how* consumer policy agencies intervene than in determining *whether* to intervene. For example, labelling requirements need to take account of the way "information overload" can degrade the quality of consumer decision-making. Equally, an awareness of the biases associated with endowment or default positions may be useful in deciding how schemes that involve opt-outs (for example, for liability) should be structured. Similarly, framing effects may be relevant to the design of regulations affecting advertising material, for instance with respect to the fat and sugar content of foods. Finally, the reliance that research in behavioural economics places on experimental trials has resulted in significant improvements in the practice and methodology of experimental economics; given those improvements, there is considerable scope for consumer protection agencies to use experiments in the design of policy instruments (such as labelling standards) and perhaps even in examining individual cases (for example, in assessing whether a particular advertisement is indeed misleading).

3.2 *Expanding role of markets*

44. Bringing the insights and methods of behavioural economics to bear on the design of consumer policy interventions may be especially important in the areas that are currently at the frontier of competition policy.

45. The last fifteen years have seen a far-reaching process of liberalisation in both the OECD countries and in many developing countries.

46. One study paper, for example, finds that taking the world's 57 largest economies from 1970 onwards, *56 out of these 57 countries have become less regulated over the period*: the only exception to the general trend is Venezuela.²² Within the 21 countries in the OECD group, the greatest decreases in market-

²⁰ See O'Hara, M. (1995) *Market Microstructure Theory*, Blackwell Publishing and Harris, L. (2003) *Trading and Exchanges*, Oxford University Press, Oxford, UK. The need to protect the returns on investment in information, and the importance of maintaining a mix of investor types in the market, can justify limitations on disclosure requirements, such as allowing reduced transparency (i.e. somewhat reduced pre- and post-trade disclosure) for block trades

²¹ See especially Mulholland, J (2007), - Behavioral Economics and the Federal Trade Commission, *Paper for the Productivity Commission Round Table on Behavioral Economics*, Melbourne, Australia

²² See Henderson P. D. (2007) - The Uneasy Trend to Greater Economic Freedom in *Political Competition and Economic Regulation* edited by Peter Bernholz and Roland Vaubel, Routledge Explorations in Economic History, pp 267 to 275

limiting interventions occurred in Portugal, followed by New Zealand, the UK and Sweden. Among the other advanced countries, Israel stands out. As for the developing countries, countries which significantly decreased the extent of market-limiting interventions include Mexico, Egypt, Turkey, India, Brazil, Argentina, Chile and Peru. Additionally and importantly, the difference in the extent of reliance on markets between the OECD group and the other advanced economies⁴, on the one hand, and the developing countries and former communist countries on the other, has narrowed appreciably since 1970.

47. This change, which in many countries reflects a greater appreciation of the merits of competition as a means of allocating society's resources, has also created significant new challenges for competition policy and for consumer policy. Those challenges have been most acute in areas such as the traditional public utilities, where issues include the difficulties of preventing nascent competition from being eliminated and the difficulties consumers face in exercising choice in areas which have long been monopolies. There have also been significant difficulties in liberalised finance markets, especially in protecting consumers who are taking choices that are often highly complex.

48. More recently, there has been discussion of the scope to introduce, and in numerous instances moves to actually introduce, greater competition in the professions and in social services (which include education, health and aged care). These are markets that are often complex for consumers to operate in, all the more so as they are relatively new or rapidly changing. Moreover, in some instances, the decisions consumers take in these markets can have very serious consequences - as is obviously true for education, retirement savings and health care - but product quality and "value for money" are difficult to observe and assess. All of these difficulties are again more acute, and potentially more laden with severe consequences, for consumers who are poorly educated or otherwise especially vulnerable, such as the elderly, the sick and the frail.

49. The issues this poses for the interaction of competition policy and consumer protection can be illustrated by considering two cases: occupational licensing, especially of the professions; and the introduction of competition into markets for social services.

3.2.1 *Occupational licensing of the professions*

50. The term "professions" embraces a wide range of services in the modern economy including accounting, architecture, legal, medical, paramedical, engineering, perhaps estate agents and other categories which shade into skilled occupations such as electricians, plumbers, and many others. In most if not all countries, entry into these occupations is regulated, as is the conduct of those who are licensed to engage in them.

51. The primary justification for these regulations lies in information imperfections.

52. Thus, a person purchasing goods or services needs to make an assessment of the quality of the goods or services. The consequences of making incorrect judgments (i.e. the risk) for a relatively simple good with few characteristics are likely to be small, especially when consumers can form a reasonably accurate estimate of the value of the good.

53. However, professional services are significantly more difficult for consumers to assess. Five key characteristics of professional services will tend to magnify the information asymmetry and its consequences. First, services are generally not observable before they are purchased as the consumer cannot inspect a service before purchase in the same direct way as can be done with most goods. Second, professional services are by their nature complex and often require considerable skill to deliver and tailor to the consumer's needs. It can therefore be difficult for the consumer to assess the quality of the service before it is purchased. Third, the quality of many professional services can be difficult to assess even *after* the service has been purchased. For example, if a person hires a lawyer to undertake litigation which is ultimately unsuccessful, it can be difficult for the consumer to know whether the legal services were poorly

delivered or that the case was inherently difficult to win. Fourth, many consumers are very infrequent consumers of professional services. Therefore, they do not have repeat purchases from which to assess quality. Fifth, the consequences of purchasing poor professional services can be significant. For example, the service may represent a large expenditure for the consumer and a defective service (e.g. a heart by-pass operation) can cause serious and irreversible harm.²³

54. These characteristics can be used to justify regulation aimed at quality assurance. Such schemes are intended to provide a guaranteed level of service quality to consumers and therefore reduce risks associated with purchasing professional services. To some extent these schemes substitute search and information gathering by individuals with information gathering and assessment through some regulatory mechanism. These arrangements can reduce the transactions cost for consumers and help the market to function efficiently.

55. However, experience also shows that these regulations often have impacts that go far beyond assuring or seeking to assure the quality of the services consumers receive. Those impacts can include:

- The *creation of a monopoly* by the exclusive reservation of work and activity to the profession. Associated with that there may be a further division of work by the exclusive reservation of work to certain categories of that profession e.g. cosmetic surgery to be done only by cosmetic surgeons;
- The establishment of *anticompetitive restrictions on entry* to a profession by a licensing or accreditation arrangement or by restrictions on entry by a foreigner or by a person from another region in that country;
- The imposition of *anticompetitive restrictions on behaviour* e.g. regarding prices or advertising or ethics; and
- There may also be *particular forms of anticompetitive conduct* e.g. price-fixing agreements and collective boycotts which, were they undertaken in other markets, would be in clear breach of the competition laws.

56. Faced with these consequences, the central challenge for policy is to find ways of addressing the legitimate concerns associated with the need for quality assurance, while creating scope for competitive forces to operate far more fully than they traditionally have. This will, by necessity, involve a tightly coordinated combination of competition policy and consumer protection tools:

- The consumer policy tools should seek approaches that are effective in protecting consumers, while not being unduly or unnecessarily restrictive of competition; while
- Competition policy should be brought to bear to ensure that subject to appropriate consumer protection safeguards being in place, competition is allowed to work where it can, including by the elimination of unjustified restrictions on entry and on competitive conduct.²⁴

²³ See Allan Fels, David Parker, Blair Comley and Vishal Beri (2001) - Occupational Regulation, in the *Anticompetitive Impact of Regulation*, eds Guiliano Amato, Laraine L. Laudati, Edgar Elgar, pp 104 to 115

²⁴ The Australian experience in this respect is discussed in Allan Fels (2006) - The Australian Experience Concerning Law and the Professions in Ehlermann (ed.) *Competition Law and the Professions*, European University Institute, Florence

3.2.2 Competition in social services

57. A similar need for close coordination between competition policy and consumer policy also arises in moves to introduce market or market-like forces into the traditional social services.

58. Thus, as noted above, steps are being taken in a number of OECD countries to expand consumer choice in the social services traditionally provided by governments.²⁵ Similar moves have also been made in a number of developing economies, including Colombia (which recently ran a program that provided vouchers to students to attend private schools),²⁶ Chile²⁷ and Indonesia.²⁸ Moreover, the World Bank has highlighted the contribution competition in the supply of services such as education and health can make to ensuring efficient use of the limited resources developing countries have for investment in social infrastructure.²⁹

59. Although these moves have great potential to improve the efficiency with which those services are provided,³⁰ they also raise very challenging issues for both competition and consumer policy.

60. For example, while most countries have long had non-government schools, parents' ability to exercise choice within the public system has often been limited by rules that allocate children to particular schools (usually on the basis of place of residence). At the same time, funding rules have limited the extent to which public subsidies to schools follow the flow of students, distorting competition both within the public system (to the extent to which schools that gain students do not similarly gain in funding) and between the public system and the non-government sector. Allowing greater parent choice, and making the income stream to schools more dependent on that choice, can be a powerful way of increasing the responsiveness of the education system to parental preferences.³¹

²⁵ For an overview see Lundsgaard, J. 2002, Competition and efficiency in publicly funded services', OECD Economic Studies, available at <http://www.oecd.org/dataoecd/42/36/22027701.pdf>

²⁶ Angrist, J. et al 2002, Vouchers for private schooling in Colombia: Evidence from a randomized natural experiment', American Economic Review 92(5).

²⁷ Hsieh, Chang-Tai and Urquiola, Miguel S., "When Schools Compete, How Do They Compete? An Assessment of Chile's Nationwide School Voucher Program" (October 2003). NBER Working Paper No. W10008.

²⁸ Bedi, A. and A. Garg 2000, The effectiveness of private versus public schools: The case of Indonesia', Journal of Development Economics 61(2).

²⁹ Hanushek, E. and L. Wolfsmann 2007, *Education quality and economic growth*, World Bank, pp. 20-21

³⁰ Hanushek, E. and L. Wolfsmann 2007, *Education quality and economic growth*, World Bank, pp. 20-21; M. Harrison 2004, *Education Matters: Government, Markets and NZ Schools*, NZBR, Wellington; C. Hoxby 1994, Do Private Schools Provide Competition for Public Schools?', NBER Working Paper No. W4978 S Bradley and J. Taylor 2002, The Effect of the Quasi-market on the Efficiency-equity Trade-off in the Secondary School Sector', 54, *Bulletin of Economic Research* p. 295-314; E Hanushek, and S. Rivkin 2003, Does Public School Competition Affect Teacher Quality?', *The Economics of School Choice* ; G Holmes, J. DeSimone and N. Rupp 2003, Does School Choice Increase School Quality?' NBER Working Paper No. W9683 May; and P Bayer and R. McMillan 2005, Choice and Competition in Local Education Markets', NBER Working Paper No. W11802

³¹ See Burgess, S., C. Propper and D. Wilson 2004, The impact of choice in education and health: a review of the economic literature', Centre for Market and Public Organisation, particularly on pp. 15-23. Such considerations are equally relevant to developing economies where as noted previously there has been a wealth of policy experiments - see for instance Patrinos, H. 2006, Public-Private Partnerships: Contracting Education in Latin America', World Bank; Barrera-Orsorio, F. 2007, The Impact of Private Provision of Public Education: Empirical Evidence from Bogota's Concession Schools', World Bank; and Patrinos, H.

61. However, securing those gains, and ensuring that they are to the ultimate benefit of students and society, involves myriad issues of policy design. To the extent to which schools move into the competitive arena, difficult questions need to be addressed about information disclosure (which is vital to the exercise of choice, but may distort the incentives facing teachers and school administrators),³² about information sharing and cooperation between schools, and about how desirable information sharing can be reconciled with effective competition.³³

62. Similar issues arise in health care. Particularly for countries that are experiencing rapid population aging,³⁴ the issues that are central to ensuring efficient provision of health care services are changing. While the provision of care for acute conditions remains of obvious importance, there is a growing emphasis on (and allocation of resources to) the treatment of chronic conditions, such as the various impairments associated with age (for instance, dementia), as well as those associated with obesity and other life-style diseases.³⁵ These are forms of care where choice by consumers (or their families) can be especially important, both because the care itself can involve a *de facto* choice of living conditions (as is the case, for example, for residential aged care), and/or because patient incentives and motivation matter greatly to the efficacy of treatment (as in the treatment of life-style conditions).

63. However, making choice work well in these areas is no easy matter; as with schools, it involves difficult questions about information disclosure and consumer rights and obligations, as well as difficult issues about how competition between providers can be reconciled with the wider social objectives that are also being pursued. Here too, different forms of expertise - of health practitioners and specialists, of competition authorities and of experts in consumer protection - need to be brought to bear in the design of market (or “market-like”) instruments.³⁶

and S. Sosale (eds) 2007, ‘Mobilizing the Private Sector for Public Education : A View from the Trenches’, World Bank.

³² In reviewing the economic literature, Burgess, S., C. Propper and D. Wilson 2004, The impact of choice in education and health: a review of the economic literature’, Centre for Market and Public Organisation conclude that (p. 16): For choice to work, the supply side must be responsive to (changes in) demand. But the form that these responses take depends on the type of performance measure used and the incentives therefore created.. If parental choice is based on the information contained in performance measures, schools have the incentive to improve measured performance. This does not necessarily mean an improvement in actual outcomes...Different performance measures may be suited to the different objectives of accountability and facilitating a choice programme. The influence of target setting and information disclosure on providers (and the unintended consequences that can result in) are discussed in Hood, C. (2006) “Gaming in Targetworld”, *Public Administration Review*, 66(4), 515.

³³ This is illustrated by cases in the UK and US where private schools and colleges have come under investigation or lawsuits for alleged anti-competitive conduct because of information sharing and cooperative practices. In the UK, private schools came under investigation in late 2006 for exchanging information on future fees - see Decision of the Office of Fair Trading No. CA98/05/2006, Exchange of information on future fees by certain independent fee-paying schools’, 20 November 2006. In the US, in 1993 the federal government successfully challenged an agreement between universities limiting.

³⁴ The Australian case is illustrative of the wider OECD trend. See Ergas, Henry and David Cullen (2012) *Providing and Financing Aged Care in An Aging Society*, available at www.greenwhiskers.com.au

³⁵ Extrapolating from similar trends in the US - see Reynolds, S. L., Y. Saito and E. M. Crimmins, 2005, The Impact of Obesity on Active Life Expectancy in Older American Men and Women’, *The Gerontologist*, vol. 45, pp. 438-444. See Ergas, Henry and David Cullen, *ibid*, for a discussion of trends in chronic disease and their implications for provision and choice in aged care.

³⁶ For a good survey of the impact of consumer choice in health markets see Burgess, S., C. Propper and D. Wilson 2004, The impact of choice in education and health: a review of the economic literature’, Centre for Market and Public Organisation, pp. 25-33

3.3 *Conclusions*

64. In summary, issues associated with the interaction between consumer protection and competition policy have received considerable attention in recent years, with some of that increased attention coming from research findings about inherent limitations on the quality and efficacy of consumer choice. It would be premature and likely incorrect to conclude from those studies that less reliance should be placed on consumer choice in a competitive market-place as the best means for promoting efficiency and social wellbeing. However, they do have important implications for policy design, most obviously of consumer protection measures. As competition and consumer policy are extended into new areas - such as emerging markets for the social services traditionally provided by governments - the lessons of that research need to be brought fully to bear.

4. **Institutional design and institutional challenges**

65. The discussion above has highlighted the interdependence between competition policy on the one hand, and consumer policy on the other, and the shared nature of the objectives they pursue. It has also highlighted the way they come together in policy design, most obviously when competition is being extended to new areas. This leads naturally to a consideration of the institutional arrangements for competition policy and consumer policy, including the question of whether they should be housed within a single institution.

66. There are both benefits and costs to placing competition policy and consumer policy within a single institution. We consider first the benefits and then turn to an assessment of the costs.

4.1 *Benefits of integration*

67. There are three major advantages to integrating the primary responsibility for competition policy and consumer policy within a single institution. These are:

- Gains from treating competition and consumer policy as instruments that can be flexibly combined and more generally managed within a single portfolio of policy instruments;
- Gains from developing and sharing expertise across these two areas; and
- Gains in terms of the wider visibility to the community, and understanding in the community, of competition and consumer issues.

4.1.1 *The portfolio of policy instruments*

68. By keeping markets effectively competitive, competition policy can reduce the work that needs to be done by consumer policy; equally, consumer policy, by enhancing the ability of consumers to exercise choice, can help make markets more effectively competitive and force firms to compete on the merits, thereby supporting the ends of competition policy. This interdependence is important because it means that there may be scope for substitution between these instruments. As a result, joining the instruments within a single armoury may allow both objectives to be pursued at lower net cost (or equivalently, with greater net gain), as the least cost instrument is used in each fact situation.

69. For example, as a general matter, competition policy, other than by prohibiting anti-competitive conduct, has relatively little scope to make markets more structurally competitive than they would otherwise be; moreover, policies that seek to de-concentrate oligopolistic markets, either through forced divestments or by subsidising or otherwise assisting entry, are often contentious and often seem likely to

impose costs that are considerably greater than the benefits. In that sense, competition authorities may have few means to alter the supply side of markets so as to make rivalry a more effective discipline. However, in those cases, action on the demand side of the market may provide an effective alternative: for example, if better consumer information, or reduced switching costs, make the demand each firm faces more elastic, that will usually create incentives for each firm to price more aggressively for any given market structure.³⁷

70. The value of seeing these instruments as being within a common portfolio of tools is accentuated by the fact that consumer policy can often be tailored to the needs of particular markets in ways that would be impossible and/or inappropriate for competition policy. For example, it would not be desirable to have a specific set of competition policy instruments that applied to (say) electricity retailing; however, the particular issues associated with improving customer information in that market may well be properly dealt with through consumer policy instruments (such as information campaigns) that are specific to the market at issue. In that sense, while competition policy is by its nature a relatively blunt instrument, interventions on the demand side of markets may be capable of addressing industry specificities in a more finely honed way.

71. At the same time, managing these instruments within a common portfolio may be an effective way of identifying, and thus avoiding or reducing, inconsistencies in policy settings. For example, mandatory product standards can limit competition by restricting low cost, low quality producers from entering markets. That harmful consequence is more likely to be revealed, and to cause corrective action, in an institution that is also attuned to the goal of promoting competition, and whose functions lead it to undertake competition investigations across a wide range of markets, than in one that is not. More generally, by ensuring that each market and the instruments brought to bear on it are seen as a whole - in terms of the functioning of both that market's supply side and of its demand side - the risk of one set of policies being used to undermine the other can be better controlled.

4.1.2 *Shared expertise*

72. Particularly but not solely in smaller economies, the stock of expertise available to the public sector for analysing complex policy issues to do with the structure and functioning of markets is likely to be very limited. As both consumer and competition policy draw on similar types of expertise, managing what expertise there is within the framework of a single institution may allow it to be used more efficiently.

73. At the same time, such integrated management may provide opportunities for professional development in which individuals are exposed to, and develop a detailed understanding of, to both competition policy issues and consumer protection issues. This is especially important when analyses are required that take full account of both the supply and the demand side of markets.

74. For example, it can be difficult to understand what (seen from the supply side) may seem to be unduly restrictive agreements without an understanding of the way the demand side of a market works. Agreements whereby insurers "steer" consumers to particular suppliers of smash repair services - by requiring consumers to only use designated repairers - are a case in point. Those agreements may seem to restrict competition for smash repair services. However, their primary justification lies in the way they limit the moral hazard problems that would otherwise arise in the market for smash repair services. Those

³⁷ This is not always the case. For example, in a market that is growing rapidly, switching costs may induce firms to bid more aggressively for customers so as to benefit from subsequent lock-in effects. Artificially lowering switching costs in such a market may attenuate price competition, at least in the growth phase. However, the reduced competition in the growth phase may be offset by more intense competition once the market size has stabilised. As a result, even in those cases, there is a trade-off between switching costs and competition

moral hazard problems arise because consumers do not bear the full costs of the repair services, while the quality of repairs is often difficult to fully observe. By seeming to limit consumer choice, the insurer can both reduce costs and increase quality directly and provide incentives for smash repairers to compete on the basis of cost and quality, rather than by exploiting consumers and insurers. A detailed knowledge of how consumers behave in situations such as these is obviously helpful to a proper analysis of what may seem an undue restriction on competition.

75. Equally, an understanding of consumer policy issues and instruments can be important in assessing possible changes in market structure, such as those associated with proposed mergers. At the simplest, knowing that an industry is one in which consumers have experienced persistent problems with the terms and conditions of service may assist in examining claims about how the relevant markets have operated in the past and might operate in future. For instance, if consumers typically face high information costs, the post-merger market structure may offer more scope for consumers to be exploited, particularly if post-merger competition would depend heavily on new entry or on the expansion of relatively small and perhaps little-known suppliers. At the same time, a close awareness of those consumer issues may help shape remedies, which could, for example, include information disclosure or product unbundling requirements.

4.1.3 *Community support and public accountability*

76. Finally, there may be benefits in terms of community support and public accountability. As far as support is concerned, there is a natural appreciation in the community of the value and importance of consumer protection. By linking its competition policy activities to the consumer protection agenda, and explaining the linkages between its competition policy decisions and the promotion of the consumer interest, a competition authority can enhance public acceptance of competition policy. This may be especially important in countries where competition policy is a relatively recent development, and where there is little understanding of the importance, role and substance of competition policy. Potentially highly controversial decisions - such as those involved in opposing mergers between powerful domestic firms - may prove easier to make and sustain if they can be clearly explained as part of a broader mission aimed at protecting and promoting the interests of consumers.

77. At the same time, at least in some countries, consumer protection has found it difficult to obtain a high degree of political priority and indeed, of support within administrative and bureaucratic elites. This has compromised both its access to ongoing funding and its ability to attract the more ambitious elements in the public service. In contrast, having well-resourced competition policy authorities is broadly seen as an important component of sound economic management. Moreover, a stint working in a competition authority may be an attractive career move for talented young professionals. Competition authorities' resulting greater access to human and financial resources may more readily spill over to consumer protection in countries where the two areas of policy share a common home.

78. As well as these gains in sustainability, integrating the missions may lead to improved public accountability. Competition policy tends to be economy-wide in its reach, and the individual actions and decisions of competition policy authorities are of broad interest to the business, legal and academic communities, as they are seen as precedents that may be extended beyond the firms and industries directly at issue in those actions and decisions. As a result, the conduct of competition authorities in respect of their competition functions is subject to quite careful and effective monitoring, which helps ensure that those agencies operate to reasonable quality levels.

79. In contrast, consumer policy is at times highly-industry specific and additionally involves many decisions that individually, have quite low stakes in absolute, economy-wide, terms. This can lead to a situation in which relatively few social actors have the incentive or ability to carefully monitor decision-

making by specialised consumer policy agencies. As discussed in more detail below, this absence of close monitoring can lead to regulatory failure, with the agency at issue being captured either by the ideology of consumer protection - without a proper appreciation of the costs regulation imposes - or by the regulated firms, which have an interest in using consumer protection to create barriers to the entry and expansion of new players. These risks are likely to be smaller in an entity that also has the competition policy functions, both because of the internal culture of such an entity and because of the close scrutiny that entity will naturally attract.

4.2 *Costs of integration*

80. Although integration of competition policy and consumer policy institutions can have benefits, it also has costs. Those costs arise from the inherent differences in the substance and implementation of these instruments, and the obstacles those differences create in practice to achieving full policy integration.

4.2.1 Differences in substance and implementation

81. Although consumer policy and competition policy share common goals, the specific instruments on which they rely differ, as does the context in which policy implementation occurs.

82. Thus, by and large, competition policy is implemented through the enforcement of the competition laws, which involves a mix of administrative proceedings (such as those used in merger clearance and in the authorisation (administrative approval) of agreements) and of litigation in court and tribunals. Typically, the case load involves relatively small numbers of cases, with individual cases that are often very large in absolute terms. Additionally, direct interaction with the public is often quite limited, with much of the information flow occurring through highly formalised processes, such as information filings and document discovery. These characteristics of the work flow have a significant influence on the structure and conduct of the agencies, including in terms of the training of staff, the types of skills and career paths that make for advancement, and the allocation of the time and attention of senior personnel.

83. In contrast, consumer policy is inherently more varied in its instruments, form and substance. As regards the instruments, while consumer policy has a conventional enforcement element (that is most marked in respect of misleading and deceptive conduct), it also covers weights and measures, product quality and safety standards, industry codes of conduct, the regulation of behaviour in individual professions and consumer ombudsman and dispute resolution mechanisms. While there are some important instruments that are economy-wide, they are usually paralleled by an extensive assortment of sector- or market-specific instruments. These rely on a broad range of enforcement instruments and in some cases (such as information and consumer education) are very “soft” forms of regulation. Moreover, the process of policy formation and implementation tends to be itself very varied and in many respects porous, with significant direct involvement with the public, a case load that involves many individually small cases, and considerable industry input into policy design. In turn, these features map into a policy process that is far more decentralised - in terms of the range of players involved - and far more geographically localised than is the formation and enforcement of competition policy.

84. One result of these differences is that consumer policy, when it is integrated within an agency that also has responsibility for competition policy, may find it difficult to attract the attention it deserves. The highly varied nature of the consumer policy case load, and the fact that many consumer policy cases are relatively small and have low stakes in absolute terms (though they may be of great significance to individual consumers), can lead to consumer policy receiving less top management attention and support than it should. The fact that much of consumer policy involves decentralised interaction with other agencies and territorial levels of government can induce a tendency to delegate the work to relatively junior levels and not to give it the funding, resources and profile that competition policy - with its ongoing stream of high visibility, large scale, litigation - invariably secures.

85. These issues arise from differences in the nature of instruments and tasks these respective policy instruments involve. In theory, of course, that could change.

86. In particular, there could be gains to consolidating consumer policy, in terms of giving it a more unified statutory and institutional basis, and in that respect making it somewhat more similar to competition policy. Indeed, in a review of Australian consumer policy, the Productivity Commission (which advises the Australian Government on issues that affect economic efficiency) has recommended that it would be preferable to rely on the generic law, rather than resorting to industry-specific regulation, in dealing with many consumer problems.³⁸ In effect, such reliance on generic law:

- Facilitates consistency in approach across consumers and markets;
- Allows regulators to deal with emerging problems without the need for new statutes — an especially important feature given that many consumer markets are evolving rapidly;
- Generally avoids boundary line problems and the gaps in regulatory coverage that can ensue; and
- Imposes relatively few costs on the overwhelming majority of suppliers who do the right thing by consumers.

87. Set against those benefits, industry-specific consumer regulation explicitly seeks to prevent certain behaviours rather than rely on the deterrent effect of the threat of prosecution for breaches of general law and possible liability for compensation. Its use, the Productivity Commission notes, is most likely to be desirable when:

- The risk of consumer detriment is high and/or the detriment suffered if things go wrong is potentially significant and possibly irremediable. (Such considerations are the primary reason why specific regulation is employed in the medical and consumer credit areas);
- The suitability and quality of services is hard to gauge before or even after purchase (the ostensible rationale for many other professional licensing regimes); and/or
- The technical nature of a product or service makes it easier for a regulator to assess breaches of appropriate behaviour against some ‘objective’ standards.

88. These considerations are well made and, at least as far as Australia is concerned, they do suggest gains in placing somewhat greater weight on achieving consumer protection objectives through economy-wide statutory instruments. Moreover, the evolution of Australian consumer law has been broadly consistent with this approach. Nonetheless, even with such a move, the major differences noted above between the nature of the tasks, skills and processes involved in competition policy on the one hand, and consumer policy on the other, seem highly likely to remain.

89. This, in turn, creates practical difficulties to seeking to manage both of these functions within a single agency of government. While these difficulties need not be insuperable, they limit the economies of scope between the functions and may make for their separate administration.

4.2.2 *Limits on integration in practice*

90. Largely as a result of the characteristics noted above, it is an inherent feature of any effective regime of consumer protection that it will involve a number of quite distinct agencies of government. Moreover, those agencies may well span separate territorial levels of administration, especially in countries

³⁸ Productivity Commission (2007) *Review of Australia's Consumer Policy Framework: Draft Report*, Canberra.

with a federal structure. This multi-agency character is especially marked when consumer protection issues arise in industries that are subject to extensive industry-specific regulation, such as financial services and health care. In those instances, the industry-specific regulators naturally play a substantial role in consumer protection issues, and indeed, often bear the primary responsibility in that respect.

91. As a result, it is not generally feasible to centralise responsibility for consumer policy to the same extent and in the same way that occurs as regards responsibility for the enforcement of competition policy. Even when aspects of the functions are combined in a single institution (as is the case with the ACCC in Australia), many important aspects of consumer protection fall outside its remit, and will likely continue to do so.

92. This implies that, in practice, the degree of integration between these policy instruments will never be complete. Rather, any integration will be selective, and hence will need to focus on those aspects of the policies which are most tightly interdependent and where the economies of scope in policy design and implementation are greatest.

4.3 *Conclusions on institutional design issues*

93. Overall, there are a number of respects in which gains can be achieved by locating responsibility for both competition policy and consumer policy in a single institution. Those gains include:

- Benefits in terms of better policy coordination, and in particular, in the selection of policy instruments to meet the needs of particular fact-situations;
- A better understanding by policy-makers and enforcers in each area of the role and limitations of the other; and
- The ability to secure economies of scope in access to resources and in the efficacy of monitoring and accountability processes.

94. However, there are also inherent limits to the possibilities for integration:

- The nature of the tasks involved in implementing consumer policy differs greatly from those involved in the administration of competition policy, reducing the economies of scope achievable through their integration; and
- It is an inherent feature of any effective policy of consumer protection that it will involve a range of agencies, and (especially in Federal countries) span several territorial levels of administration.

95. These conflicting pressures can obviously be addressed through a range of quite differing approaches. In practice, what appears most important is:

- To ensure that the competition authority has in-house access to the skills involved in the formulation of consumer policy, and at the very least a watching brief with respect to consumer policy, as well as scope to intervene in consumer policy decisions that have material competition implications; and
- That there be within government, an entity that has “whole of government” oversight of consumer protection, and that exercises that oversight in a manner mindful of competition concerns.

96. Periodic surveys of particular instruments - such as occupational licensing, or restrictions on advertising - aimed at reviewing whether they are consistent with efficient competition, could play a useful and important role in this respect. These surveys would provide a regular opportunity to review whether

the objectives pursued through whatever restrictions are imposed using these instruments could be achieved in less restrictive, or more efficient, ways. Developing a program of such reviews, starting with those instruments that are most likely to be unnecessarily restrictive, could be an effective approach to giving such a process a structure and clear time-line.

5. Regulation and Competition

97. Having reviewed the issues in respect of consumer protection, we turn to discuss those that bear on regulation.

98. It is obvious that there are some activities in which it is efficient for only a single supplier to serve an entire market. These activities, which are generally referred to as natural monopolies, are normally characterised by significant economies of scale and scope in at least some of the functions required for supply. To the extent to which realising these economies of scale and scope involves substantial sunk investments - that is investments in assets that, once dedicated to a particular use, have little or no value in alternative uses - an incumbent firm supplying the service will not face effective competitive disciplines.

99. Were society fortunate enough to be able to turn to an omniscient and omni benevolent social planner to direct economic activity, the control of natural monopoly would pose little problem. In reality, society is not so blessed and difficult choices must be made about the extent and nature of the controls placed on natural monopoly suppliers.

100. These choices are difficult because all known means of control are imperfect. Historically, in most economies outside the United States, control was primarily effected by means of government ownership, that ownership then bringing with it a greater or lesser degree of direct supervision, most often by a Ministerial department.³⁹ Since the 1980s, however, government ownership of commercial operations has fallen out of favour and government-owned utilities have been privatised in a wide range of countries. Even where privatisation has not occurred, or been incomplete, direct control by Ministerial department has been viewed as problematic, with a preference for control structures that impose greater separation from the political process. That raises the question of how those control structures should interact with competition authorities.

101. Inevitably, there are many points of overlap between the regulation of what might broadly be called the former public utilities and competition authorities. Those interactions will be most acute where regulation raises competition issues, as it does at the boundaries between natural monopoly activities and potentially competitive activities. Interactions of this kind also arise when market structures change in regulated industries, for instance through mergers. In every country, regulatory and competition authorities have had to develop processes and protocols for managing these interactions.

102. Given those interactions, it is natural to think there could be economies of scope between the regulation of natural monopolies and the work of competition authorities. After all, both involve a mix of economic and legal analysis and the forensic skills each of those requires; both seek to promote economic efficiency and the long term interest of end-users; and they may at times be alternative ways of pursuing those goals, creating potential benefits where the choice between these instruments can be internalised in a single decision-making process.

³⁹ See for example José A. Gómez-Ibáñez (2009) *Regulating Infrastructure: Monopoly, Contracts, and Discretion*, Harvard University Press, Cambridge, Mass.

103. However, it is also important to consider the differences between these domains of activity, and those differences' implications for institutional design.

104. At the highest level of abstraction, which necessarily involves some simplification, the difference between competition policy and regulation is that while competition policy tells firms what not to do, regulation involves telling them what they are to do. Competition policy sets bounds on acceptable behaviour; in practice, these bounds are likely to be very broad indeed. Regulation typically, though not inevitably, selects a much narrower range of points, and directs the regulated entity to seek to attain that range. Regulation therefore **prescribes**, while competition policy **proscribes**. Moreover, it follows that while regulation is inherently *ex ante* in its approach, competition policy is largely *ex post*, or at the very least, inherently *reactive*.

105. Put in such stark terms, the distinction is a caricature. But it has merit in highlighting a difference in social function, which then has implications for the characteristics of the institutions by means of which regulation and competition policy are respectively implemented.

5.1 Regulation

106. Whatever the most desirable relation between a competition authority and monopoly regulators may be, what is clear is that there is a long-accepted case for some form of monopoly regulator.⁴⁰ That case has four key elements.

107. First, left to their own devices, natural monopoly suppliers will have and exploit market power. Given that they will not be in a position to exactly match the price they charge each consumer with that consumer's willingness to pay, some inefficiency will result.

108. Second and related, consumers themselves cannot contract with natural monopoly suppliers for efficient supply. They cannot, in other words, form a coalition that collectively imposes on the supplier efficient terms and conditions, as might occur in a purely hypothetical 'Coase' bargain. As a result, a 'buyer's agent' is needed to contract with the monopoly supplier on society's behalf.

109. Third, in most circumstances, the buyer's agent referred to above cannot contract with the monopoly supplier once and for all, and then vacate the field (as might happen in a pure concession contract). To begin with, future events are too uncertain for a once and for all contract to be efficient for any of the parties - such a contract would almost inevitably involve an unacceptable level of risk. Additionally, the task of devising a contract that covered all conceivable eventualities probably exceeds human problem-solving abilities, but even if feasible, would involve great costs. Finally, even if a comprehensive contract could be devised, a specialised enforcement agent would likely be needed. This is because each individual consumer is likely to have too little at stake to bear the costs involved in securing contract compliance. As a result, the buyer's agent must be able to establish, review and revise the terms and conditions of supply, and monitor and enforce compliance.

110. Fourth, specialised expertise is required to discharge these tasks efficiently, and there are fixed costs and associated scale economies involved in establishing and maintaining that expertise. This is all the more the case as effectiveness in these activities involves significant 'learning by doing.' An arrangement in which responsibility for these tasks is assigned to a standing pool of specialists will be more efficient than one in which the fixed costs need to be periodically re-incurred.

⁴⁰ Richard Schmalensee (1979) *The Control of Natural Monopoly*, Lexington, Mass.

5.1.1 *The problem with regulation*

111. Although not always correct, these arguments are certainly plausible in a wide range of cases. Having said that, however, the same arguments also point to some weaknesses of the regulatory solution.⁴¹

112. Economists have extensively analysed these problems in terms of the difficulties a beneficent regulator has in acquiring the information needed to identify and hence impose on the firm an efficient solution. But while these difficulties are real, there are also economic costs that arise from the nature of the regulatory solution itself. Three points are especially important in this respect.

113. The first arises from the necessarily incomplete nature of the regulatory contract. Society cannot specify to its agent - the regulator - exactly how it is to behave in all conceivable eventualities, just as society cannot enter into a complete, in the sense of comprehensive and exhaustive, contract with the service supplier. There is consequently a degree of discretion that is inevitably afforded to the regulator.

114. The greater the resources accessible to the regulator - in terms of on-going funding and expertise - the greater the scope the regulator has to use that discretion. While securing economies of scale in regulation may make for strong, well-resourced regulators, it also gives regulators a larger armoury on which to draw.

115. Second, it cannot be assumed that the regulator, in exercising its discretion, will do so in a way consistent with the interests of consumers. The assumption of beneficence, at least in so far as it assumes that there is no difference between the preferences of regulators and those of society as a whole, is necessarily suspect.

116. Third, it is costly for society to monitor quite how the regulator makes use of its discretion, and on that basis to seek to influence the regulator's behaviour. However, the extent of these monitoring costs will differ as between different elements in society - a point with important implications that are discussed below.

117. In short, regulation involves a grant of power by society to an entity which it cannot completely control and which, as a result, may pursue interests other than those it is intended to represent.

118. Economists refer to situations in which one party vests control over resources in another, without being fully able to specify and monitor their use, as involving 'principal agent problems.' In these situations, the principal - whose resources are being deployed - is not in a position to enter into a complete contract with the agent, to whom control over the resource is being transferred; nor can the principal completely monitor the agent's performance; finally, the agent's interests differ, at least in part, from those of the principal.

119. In a commercial setting, principal-agent problems reduce output, as the principal gets less value from reliance on the agent than it otherwise would. Equally, in the regulatory setting, principal-agent problems mean that the social costs associated with natural monopoly are less efficiently tackled than they would be, were perfect contracting possible. In other words, because of principal-agent problems, regulation imposes costs of its own.

⁴¹ Henry Ergas (2013). "Why Johnny can't regulate: the case of natural monopoly"; *Agenda: a journal of policy analysis and reform*, 20 (1), 47-54.

5.1.2 *The extent and nature of regulatory costs: the capture model*

120. The extent and nature of the costs regulation imposes depends on how, and with what economic consequences, regulatory discretion is exercised.⁴²

121. At an abstract level, regulatory decision-making can be modelled as a situation in which regulators, like all other agents, maximise their utility - that is, the net benefit they obtain from the activity they carry out. However, they do so subject to the constraints imposed by the environment in which they operate. More specifically, it seems reasonable to suppose that regulators incur 'costs' (not necessarily in the form of a financial penalty, but of a reduction in welfare) when they antagonise those who exercise the most effective surveillance of their activities, and secure 'revenues' (again, not necessarily in the form of a financial gain, but of an increase in welfare) when their conduct meets the expectations of those most effectively monitoring them.

122. Obviously, these are a considerable simplification of the myriad factors shaping regulatory decision-making but they are helpful in defining an analytical approach to the issues. They particularly highlight the fact that the behaviour of regulators is shaped, at least in part, by the nature of the monitoring to which they are subjected.

123. In the 1960's, it was noted that this feature of the regulatory process can lead to some powerful inferences about how regulators will behave. The logic underpinning these inferences can be summarised in the following terms.

124. As a general matter, it is clear that the extent of investment that parties will make in monitoring (and then seeking to influence) decision-making processes is a function of (1) how much they have at stake in those processes, (2) how continuously they are affected by those processes and (3) the opportunities they have to use (or more generally 'trade') resources they control in exchange for information about those processes. There is, in each of these respects, a marked asymmetry between the regulated firm on the one hand, and the consumers regulation is intended to benefit on the other.

125. Regulatory decision-making is a high stakes process for the regulated firm. As a result, it has the incentive and ability to incur the fixed costs that monitoring and seeking to influence the regulator involves.

126. At the same time, the regulated firm interacts on a repeated, indeed likely nearly continuous basis, with the regulator. For the regulator and the regulated, the situation is, in other words, a repeated game. As a result, just as the regulator 'learns by doing' about the firm, so the firm 'learns by doing' about the regulator. Repeated interaction thereby reduces the regulated firm's monitoring costs.

127. Last but not least, most regulators, to do their job, require substantial input from the regulated firm. Coercive mechanisms will only go so far in securing this input. There is consequently a situation of mutual exchange. Ongoing interdependence (the repeated game nature of the relationship) then translates into an ability by each of the parties to 'reward' cooperative behaviour and 'punish' uncooperative behaviour, allowing the regulated firm to secure information and influence.

128. In contrast, end-consumers typically have relatively little at stake in regulatory decision-making. Moreover, very few consumers have on-going contact, or are in a position to trade information, with

⁴² For a survey of the relevant literature, see Henry Ergas (2008) *Wrong Number: Resolving Australia's Telecommunications Impasse*, Allen & Unwin, Sydney.

regulators. As a result, it would not make sense for any individual consumer to invest substantial resources in monitoring and seeking to influence regulatory outcomes.

129. Additionally, given the sheer number of end-consumers, high costs would be required to organise and sustain a collective investment in monitoring and influencing effort. The likelihood of any single consumer contributing to these costs is all more reduced as the vast bulk of the gain associated with this investment would flow to other consumers - in technical terms, there would be a 'spill-over' or 'externality.' Each individual consumer will then be tempted to 'free ride' or at least 'cheap ride' on the effort of other consumers, making it difficult to initiate and maintain collective action. There is no such spill-over or externality, or more generally collective action problem, for the regulated firm, as any benefits it can obtain by influencing the regulator are captured entirely by it.

130. In short, regulated firms have the means and motive to invest in closely observing and trying to alter regulatory outcomes. In contrast, end-consumers individually are unlikely to have the expertise and access needed to credibly monitor and seek to influence the regulator, and will face substantial organising costs if they try to do so collectively.

131. From this can be derived the hypothesis that by and large, regulators are likely to favour the interests of the regulated firm relative to those of end-consumers. In the extreme, regulators, to use a phrase once common in the economic literature, will be 'captured' by the regulated firm.

132. To the extent to which such 'capture' occurs, society will suffer two sets of costs: first, the direct inefficiencies resulting from excessive prices for regulated goods; and second, the waste of resources associated with investment in seeking to influence regulatory processes. The second of these is usually referred to as 'rent seeking', with the costs of rent seeking being a pure loss to social income.

5.1.3 What's wrong with the capture model?

133. The 'capture' story seems somewhat less plausible viewed from a contemporary perspective. To begin with, it ignores the fact that consumers are heterogeneous, and that some consumers do have a great deal at stake in individual regulatory decisions. This is most obviously the case for those consumers for whom the goods at issue are intermediate inputs - for example, providers of long distance telephony service buying access to the local telephone network (the 'local loop') from a regulated incumbent supplier. Consumers such as these can both monitor and seek to influence regulatory outcomes themselves and form coalitions aimed at so doing.

134. Additionally, even for end-consumers, the simple story probably over-states the costs involved in monitoring, and seeking to influence, the regulatory process. Most obviously, the media, at least in those countries which have a free press, has proved remarkably effective in following and giving wide publicity to, regulatory decision-making. Moreover, though individual end-consumers may have little at stake in individual regulatory decisions, it may well be that these consumers are especially aware of, and potentially resentful of, price increases for goods whose prices are politically controlled and for which there are no alternative sources of supply. The fact that these goods are consumed, and billed for, on a repeated basis, may further increase the attention consumers' pay to their prices.

135. Reflecting these factors, the political system, which controls regulators' access to resources, is likely to be far more sensitive to consumers' perceptions of regulatory outcomes than the simple capture story suggests.

136. Concerns about the legitimacy of the privatisation process, which in many jurisdictions is controversial, will further heighten the political system's sensitivity to consumer views. So too will the controversy that still surrounds those activities which have been opened to competition - such as

telecommunications - but where regulatory controls remain in place over incumbent providers. In both of these cases, there seem likely to be strong political pressures for tangible and highly visible consumer benefits to be realised from regulated entities, even if these benefits are not sustainable.

137. Particularly where regulators are relatively new, and hence still attempting to gain legitimacy, these external pressures may well find a favourable response. That regulatory capture could arise and persist in these circumstances seems unlikely.

5.1.4 *Time inconsistency*

138. The fact that capture seems unlikely does not mean, however, that the regulatory process will operate without economic cost. Rather, the nature of the regulatory distortions will differ from those that the capture model points to. In particular, the circumstances set out above create a risk of 'time inconsistent' behaviour by regulators.⁴³

139. "Time inconsistency" is a term that originated in economic research about monetary policy, and more specifically, about the behaviour of central banks. Loosely, it refers to situations in which the central bank has an incentive before the fact to commit to a low inflation policy, thus promoting investment. However, once that investment has occurred, if the economy experiences slower growth, the central bank can gain by breaching its commitment and adopting a more inflationary stance - after all, the investment, once made, will remain in place, and the bank's expansionary policies will allow an increase in output, albeit at the expense of those who financed the investment. The bank's incentives before the fact (*ex ante*) therefore differ from those after the fact (*ex post*). Knowing this, investors will be more cautious about the value they place on the central bank's statement of intentions, and so the bank, if it is to attain a high level of investment, will need to establish its credibility - including by being more contractionary than it would otherwise choose to be.

140. Equally, in a regulatory context such as that set out above, time inconsistency may appear likely, especially to investors in the regulated entity. These investors may well fear that once the assets required by the regulated entity are sunk, the regulator - despite any commitments to allow a reasonable return on the underlying investments - will reduce prices below economic levels, effectively expropriating the investors at issue. By thus acting opportunistically, the regulator can maximise its utility, at least for some time. The fact that (1) regulated assets typically have very long lives, (2) operating costs are usually very low relative to capital costs (so the assets continue to be operated even if price is forced far below full cost recovery), and (3) for many utilities, the bulk of required investment is already in place, may mean that it takes a long time before the social costs of regulatory opportunism become manifest.

141. Even if regulators do not act in a manner that is time inconsistent, the social costs of the risk of time inconsistency will still be felt. In particular, investors that are vulnerable to the risk of opportunistic regulatory behaviour will require a premium before they commit funds to sunk assets. Equivalently, investors will wait to invest until the demand/supply balance is especially stressed (in the sense of demand being high relative to supply). Society will thereby obtain less, and more costly, service.

⁴³

The foundational paper on time consistency is Kyland, F. and E. Prescott, (1977), 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', *Journal of Political Economy*, 85, pp. 473-92. For applications to regulation see Levine, P., J. Stern and F. Trillas, (2005), 'Utility Price Regulation and Time Inconsistency: Comparisons with Monetary Policy', *Oxford Economic Papers*, 57(4), pp. 447-478 and Ergas, H. (2009) 'Time Consistency in Regulatory Price Setting: An Australian Case Study', *The Review of Network Economics*, vol 8, Issue 2, pp. 153-163.

142. Clearly, if regulators could enter into complete and credible contracts with the regulated entity, the issue of time inconsistency would not arise - just as capture would not occur. In this sense, time inconsistency is simply another side of the problem of regulatory discretion: that economically efficient regulation seems difficult if not impossible without some, perhaps very substantial regulatory discretion, but no less difficult with it.

5.2 *The implications for institutional design*

143. In short, the design of regulatory institutions has to balance a number of factors. Central among these are the gains and losses from institutional specialisation.⁴⁴

144. The more narrowly specialised an institution is, the greater the extent to which it can benefit by having clearly defined tasks. These benefits include those that arise from attracting and retaining specialist skills; having senior management entirely focused on the area of specialisation; narrow but potentially effective monitoring by those being regulated; and enhanced accountability if the having a more limited range of responsibilities facilitates the assessment of performance.

145. There are, however, four sets of costs that arise from narrow specialisation.

146. To begin with, specialisation may increase the resource costs involved in regulation as it prevents economies of scope from being realised. For example, an industry-specific regulator may not be able to fully utilise the specialist skills involved in determining the cost of capital; it will therefore either incur the transactions costs of contracting for these skills on an episodic basis or (should it choose to bring those capabilities in-house) those of less than full capacity utilisation.

147. Second, the narrower a regulator's remit, the greater the risk of arbitrary distortions to resource allocation. For example, if (say) the telecommunications regulator sets regulatory parameters differently from the electricity regulator, the allocation of fungible capital as between these will be distorted, imposing efficiency losses.

148. Third, the more narrowly specialised a regulatory authority is, the more likely it is to encounter boundary issues and hence have to engage possibly costly coordination processes. The costs of those processes, including the authority's own loss of control over the decision, may induce an excess reliance on the instruments the authority itself controls, compared to those instruments which have been vested in other entities.

149. Fourth, the greater the extent to which an entity is specialised, and the narrower the area over which it has a direct impact, the more limited will be the range of external parties that monitor its behaviour. This may forego scale economies in the monitoring function itself (as the costs of monitoring have a fixed component, and may not rise proportionately with the decision-making scope of the regulator). Even more importantly, it may increase the risk of pathologies such as capture (in which the consumers' agent colludes with the supplier at consumers' expense) and of empire-building and goal displacement (in which the entity's leadership maximises its own preferences, rather than seeking to protect those of consumers).

⁴⁴ See generally Komesar, N. K. (1997), *Imperfect Alternatives: Choosing Institutions in Law, Economics and Public Policy*, University of Chicago Press, Chicago and for applications to the design of regulatory institutions Ergas H. (2009) 'Error and Design: Economics in (and some Economics of) the Australian Competition Tribunal', *Agenda: A Journal of Policy Analysis and Reform*, vol 16, no 3..

150. In very large economies, it may be that these costs are viewed as manageable, and insufficient to outweigh the benefits of specialisation. However, that is less likely to be the case in smaller economies.

151. For those smaller economies, at least two options could be relevant. A first combines several, possibly all, regulated industries, vesting their regulation in one or more 'networks regulator', as in Germany. A second, as in Australia and New Zealand, places responsibility for regulating the former public utilities in the competition regulator, albeit with some limitations and exclusions.

152. The advantage of the first approach is that it secures economies of scale and scope in network regulation, potentially largely addressing the four concerns set out above. In practice, however, much depends on the legislative and administrative context. For example, if the relevant legislation specifies quite different approaches to the regulation of (say) rail access charges from (say) access charges for electricity networks, at least some of the potential economies of scale and scope will not be realised. On the other hand, even in those instances, there may be gains nonetheless, for instance, in terms of the scope to manage specialist resources as an integrated, cross-sector, pool. Additionally, the authority may benefit from 'spillovers' between sectors in establishing and maintaining a reputation - for example, for avoiding time-inconsistent behaviour. Last but not least, a wider coalition of interests may monitor the performance of its leadership, reducing the principal-agent problems.

153. The advantage of the second approach, at least in theory, is that it extends the range of instruments that the authority can bring to bear. For example, it may be that the most efficient solution to a particular regulatory problem is to restructure the market in ways that promote competition and then more vigorously enforce the competition rules. By 'internalising' into the same authority the competition and regulatory instruments, the authority may be more inclined to efficiently mix and match problems and instruments, avoiding the 'silo mentality' that can compromise good decision-making. At the same time, there may be instances where identifying the efficient regulatory solution requires an analysis of competition impacts, which such an integrated authority may find it easier to undertake.

154. However, those benefits can prove illusory if the sheer scale of the authority's remit means it struggles to ensure the efficient use of its own resources. In particular, senior management may be too thinly spread, if it must take both the full suite of decisions associated with the regulation of former public utilities and the day to day administration of the competition laws. Moreover, it may be difficult, if not impossible, for the public to assess the quality and performance of senior management, as its accountabilities are so broad and diffuse. And to make matters worse, the *ex ante*, compulsion-oriented, approach of a regulator may not sit well with the *ex post*, compliance-oriented, spirit of the competition laws, and induce a blurring in the authority's internal culture, by, for instance, giving legitimacy to 'command and control' methods.

155. As well as these drawbacks, there are some inherent gains from horizontal rivalry between competition authorities on the one hand and regulatory authorities on the other. For example, the competition authority can play a useful role as an advocate for competition in regulated industries, even in instances where the industry regulator might prefer a different approach. The separation between them encourages each to monitor the other, and can help ensure that the competition authority, in its advocacy role, articulates competition concerns when the industry regulator has not sufficiently taken them into account. The National Broadband Network in Australia could be a case in point, as - had the competition authority not been responsible for telecommunications regulation - it might have more forcefully expressed misgivings about a regulatory approach which expanded the regulator's powers at the expense of competition.

5.3 *Implications*

156. Inevitably, institutional design is a matter of trade-offs. In the absence of much rigorous discussion of its determinants, the considerations set out here are necessarily exploratory in character. Moreover, it is obvious that national factors will play a key role, including previous experience. And even then, no approach is likely to prove good for all times; rather, the choice of approach will depend partly on the expectations, ambitions and concerns of legislators.

157. For example, in Australia, the decision to vest responsibility for economic regulation of telecommunications in the ACCC was shaped by all of the following factors:

- The expectation, which proved unfounded, that industry-specific telecommunications regulation would 'wither away', as a rapid transition to competition was envisaged. 'Internalising' telecommunications regulation in the ACCC was seen as a way of expediting this transition;
- The perception that the previous industry-specific regulator, AUSTEL, had not worked satisfactorily, and dominated by an engineering led, command and control, culture;
- The desire to achieve economies of scale and scope in the regulatory function itself, including by spreading its overhead costs in the ACCC, which was also absorbing the then still important functions of price surveillance.

158. However, it is hardly clear that any of these factors still has relevance. Indeed, for reasons that echo those set out in the previous section, recent reviews have called for the government to separate responsibility for the regulation of the former public utilities from the ACCC and vest it in a 'networks regulator'. These reviews raise the concern, among others, that the ACCC may have too wide a span of control, which impedes its effectiveness and accountability.

159. Overall, the control of natural monopolies is inevitably problematic. On the one hand, leaving these firms unregulated may allow them to impose substantial efficiency costs. On the other hand, all forms of control are themselves imperfect, and to the extent to which they undermine the efficiency of key parts of the infrastructure, can be even more costly than allowing consumers to suffer from prices that - compared to an ideal benchmark - are too high.

160. Optimising institutional design is a crucial element in trying to manage this dilemma. Without claiming to have found answers, this paper has sought to identify the right questions.

6. Conclusions

161. It has been emphasised that consumer policy can ‘activate’ competition policy - that is, can help bring competitive processes to life, giving them the vitality they need to achieve the objective of making markets efficient and effective.⁴⁵ Similarly there are arguments albeit weaker that economic regulation can bring about enhanced market outcomes.

162. This is so even though there is also on occasions a risk that the instruments of consumer policy and economic regulation, rather than serving the interests of consumer, will be used to restrict otherwise desirable competition. As world markets become ever more integrated, this danger also becomes more pressing. Paternalistic and public interest justifications can be deployed for many purposes, and not all of them are socially desirable.

163. This is not to suggest, however, that there should be any doubt about the importance of consumer policy and indeed about economic regulation (although the conclusion regarding the latter is more qualified). Long-standing concerns about the need to protect consumers, and especially the most vulnerable among them, not only retain their validity but are even more significant as market mechanisms are introduced into ever more parts of our economies and societies. The introduction of competition into these areas needs to be closely coordinated with the development of effective consumer safeguards, which is a challenge which largely remains to be met. There are similar issues regarding regulation. The imperative of policy coordination is therefore as pressing as ever.

164. There may, however, be no magic bullets that can fully meet that imperative. The reality is that competition policy, consumer policy and economic regulation will always differ in the range of instruments on which they rely, key features of the tasks involved in their implementation and the levels of government that they involve. This, as well as history, may limit the extent to which there can be institutional integration. As a result, what may matter most is that competition policy authorities have the expertise needed to be effective advocates in the many dimensions of the consumer policy and economic regulatory process whilst consumer agencies and economy regulators likewise have competencies in competition policy; and that there is, in central government, ongoing attention to the need for consistency between these policy instruments. Periodic surveys of particular instruments - such as occupational licensing, or restrictions on advertising - aimed at reviewing whether they are consistent with efficient competition, could play a useful and important role in this respect.

165. Similar conclusions apply to the interaction of competition policy and economic regulation. The case for vesting these in a single entity is not compelling; however, it is apparent that the competition authority must be capable of monitoring the conduct of economic regulation and should be vigilant in taking up opportunities to advocate reliance on competition, where that is feasible and appropriate.

⁴⁵ Sylvan, L. 2004, Activating competition: The consumer - competition interface, *Competition & Consumer Law Journal*, pp. 191-206.