

Can Limited Government Intervention Improve Market Competition?

How can government intervene in the marketplace and not discourage competition? This question has become vitally important as many countries of the world move to create free markets and as global competition heightens. In a draft report written for the Organization for Economic Co-Operation and Development, Dr. David Wilkinson of the Graduate School of Management and School of Business, La Trobe University, Melbourne, Australia, suggests that government intervention can help to achieve social goals in ways that do not discourage competition if the right policy tools or instruments are used.

In his report, *Improving the Cost-Effectiveness of Government: Alternatives to Command and Control Regulation*, Wilkinson states that there are two major reasons for government intervention into the market: (1) to accommodate for areas where the market fails to operate efficiently; and (2) to achieve social objectives such as equity and consumer protection. He points out four major conditions under which the market does not operate efficiently. The first is when it attempts to provide **public goods**, or goods that are "nonexcludable" (Any number of people can consume the product or service without diminishing the capacity of others to also consume the product or service.) and "nonrivalrous" (Once the good or service is produced, the supplier is unable to exclude those who do not pay for its consumption.). For example, street lighting may be non-excludable because once it is operational, it is hard to exclude anyone from enjoying its benefits. Similarly, a given level of national defense is nonrivalrous because all citizens benefit from it without reducing the benefit of others, and new citizens may also enjoy its benefits without reducing the benefits of those already being defended. In these cases, it may be more efficient for government to provide these services.

The second condition occurs when the production of goods or services in the marketplace produces negative "spillover effects", such as pollution. These spillover effects are referred to as **externalities**, and since the spillover costs are not borne by the original party (e.g. the polluter), there are no market incentives to reduce the level of activity which led to the externality. Therefore, government may have to intervene to reduce the negative spillovers through taxation or regulation of the activity that led to the unwanted public outcome (externality).

According to Wilkinson, the third condition that leads to market failure is **natural monopolies**. This condition occurs when it is more efficient for one firm rather than two

or more firms to produce the required output. For example, until recently, local utility companies, and even cable television companies, enjoyed what might be termed natural monopoly markets. In these situations, government may have to intervene and initiate price controls or the creation of third party property rights.

Finally, market failure can occur even in when competitive structures exist due to **information asymmetries**. Information asymmetries occur when consumers do not have the same level of information about a product or service as producers do. This may result in lower quality products driving higher quality products out of the market. In such cases, government may have to intervene to impose minimum information requirements (e.g. labeling) or to facilitate the proper identification of appropriately qualified suppliers (accreditation).

Wilkinson contends that governments also intervene in the marketplace to achieve **social goals**. These may include income redistribution, consumer protection, and public health or environmental concerns. In addition, governments intervene to **protect consumers**; for example, in the case of smoking, governments have forced cigarette companies to put health warnings on cigarette packages.

However, as Wilkinson points out that governments have traditionally tended to rely heavily on **command and control** regulatory options when intervening in the market place. In other words, directives from government are given, compliance is monitored, and noncompliance is punished. Examples include **price regulation** of natural monopolies in the energy and transportation sectors of the economy; **quantity regulation** to control the use of such undesirable products as fluorocarbons; and **direct information provision**, where firms are required to disclose information such as appliance energy-efficiency labeling or automobile mileage ratings. Individual firms often want only to know what they must do, then be left alone to go do it. Command and control regulations can provide a yardstick that allows government, the general public, and regulated firms to know what is required and whether it is being achieved. This is essential if enforcement is to be fair and effective.

Wilkinson cautions, however, that command and control regulations tend to have significant shortcomings. They promote inflexibility when they do not take specific circumstances that affect individual firms into consideration. Technological innovation in particular can be severely stunted by rigid regulation. Competitiveness is essential to maintaining quality of life in an open market. Consequently, regulations that block market innovation can impose heavy costs in terms of desirable economic growth and jobs.

Wilkinson's report offers several alternatives to traditional command and control regulation. These are designed to allow the market to work as efficiently as possible, even with government intervention. Two fundamental approaches are proposed: (1) alternative regulatory designs; and (2) non regulatory incentives.

Alternative Regulatory Designs

● *Performance Based Regulations* specify desired outcomes or objectives in lieu of the means whereby outcomes or objectives must be achieved. It is a method best suited for industries experiencing rapid technological change that quickly outdates regulations; increasing compliance costs; and strong compliance incentives because of their close alignment with community and consumer expectations.

● *Safe Harbors* allow regulated entities the choice of complying with detailed rules or developing optional approaches that meet performance measures. Firms have the choice of following prescribed regulations or producing their own mechanisms of achieving performance standards. Safe harbors are beneficial in cases where low understanding of affected parties exists; where an industry is comprised of smaller or newer firms; and where supporting documentation is easily available.

● *Waiver or Variance Provisions* begin with prescription regulations, but allow waivers on a case-by-case basis where a firm can demonstrate equivalent performance. They are most useful in cases where innovative approaches achieve the same performance as prescriptive regulations.

● *Process Regulations* require businesses to demonstrate a systematic approach to controlling and minimizing risks. Businesses must undertake hazard analysis, identify critical control points and undertake on-going monitoring to assess whether controls are within critical limits. Process regulations are well suited for complicated situations having many potential points of failure, especially where that failure can have significant adverse consequences for health and safety, environmental management, or maintenance of food standards.

● *Automatic Updating* allows future needs to be anticipated and provided for through the use of formulas (i.e., permissible emissions can be tied to ambient air quality, or monetary controls that vary with inflation.). This concept is most applicable to situations where changes in standards, requirements or outcomes occur frequently.

● *Ex-post Control* occurs where administrators do not respond within a deadline and approval of processes is automatic. Other than where there is clear knowledge of either market failures or community expectations, ex-post controls are theoretically applicable to virtually every market condition, activity or industry. Unfortunately, businesses may not know what is allowable until after an event has occurred.

● *Rewarding Good Behavior* involves incentives such as reduced fines for self-reported violations, or decreased frequency of inspections if a business is found to be free of violations for a sustained period. Rewards for such behavior are appropriate when economic incentives are likely to increase the incidence of good behavior.

Non-Regulatory Incentives

■ *Informational Measures:*

◆ *Public Education Programs* work best when the problem to be addressed results from a lack of knowledge among consumers, citizens or participants in an industry; where target audiences can be reached easily and economically; and where a *light-handed* approach is appropriate.

◆ *Information Disclosure* requires dissemination of information about the attributes of products or processes (e.g., hazardous substances in use). Problems are best suited to information disclosure when information asymmetries exist; when the likely benefits (of impact or behavior) exceed the costs of information provision; and when more information will not translate into more confusion for consumers.

◆ *Persuasive Approaches* may be necessary when regulation has reached its limits in changing behavior. However, information provided to relevant parties will not always automatically change behavior.

▼ *Economic Incentives* are corrective taxes, charges and subsidies applied to resources that are priced too low. They effectively assign prices to otherwise unpriced goods. Such incentives are useful when taxation or expenditure can help correct market failures or when activities being regulated are financially based.

Even if done experimentally, much would be learned about how to bridge the gap between the promise of PB² and the current flagging and unacceptable performance by many Florida State agencies in implementing program outcomes to the fullest extent possible.

▼ *Tradeable Property Rights* allow government to intervene in business activities when production or consumption must be limited in the public interest. The government issues permits that can be bought and sold in the market and which have the aim of either allocating scarce resources or seeking firms to be responsible for externalities such as pollution. Tradeable rights work when the rights can be easily specified; when transaction costs are low; when a competitive market can be sustained, thus limiting market entry; and when the desired level of output is measurable and measurements are cost-effective.

▼ *Risk-Based Insurance* provides a mechanism for consumers and producers to reduce individuals' and the community's exposure to risks and thus minimizes their respective costs. These costs may not be fully incorporated into the anticipated costs or price of an activity. In circumstances where risk or uncertainty is not adequately accounted for by individuals or firms, governments can lower the costs associated with risks by establishing or merely promoting insurance schemes. This method should be used when a clear market failure occurs which makes it impossible for individuals or firms to take out private insurance.

▼ *Negative Licensing* is designed to ensure that incompetent or irresponsible manufacturers are precluded from operating in a certain industry. Negative licensing is preferred where government agencies intentionally wish to exclude firms with certain characteristics (e.g., serious criminal convictions) rather than specify requirements for

licensing. Negative licensing is preferred when monitoring requirements are low or when screening processes are already carried out by some other organization or law.

🚩 *Voluntary* agreements are non-binding contracts between equal partners, one of which is the government and the other a private body (or group of private bodies) in which incentives for action arise from mutual interests rather than from sanctions. Such agreements are appropriate where there is sufficient power and common interest within an industry to deter noncompliance, or when the cost of non-compliance is small.

🚩 *Self-Regulation* is an arrangement in which an organized group regulates the behavior of its members. Rules are most likely to be obeyed if they are made by insiders, and changes and updates can be made more rapidly. Self-regulations are appropriate under the same conditions as voluntary agreements.

🚩 *Co-Regulation* typically involves an industry organization, or a representative thereof, formulating a code of practice in consultation with the government. This method is best suited to situations when industry assessment is easily conducted; there is a large commonality of skills within the industry; incentives or interests are aligned or are self-enforcing; and professional independence is a major consideration.

An Example: Licensing Real Estate Agents in Australia

Before 1995, the Australian state of Victoria had a two-tiered system for licensing real estate agents. Agents and sub-agents had to obtain personal licenses. Sub-agents had to be assessed by an independent regulatory body to ascertain whether they met the eligibility requirements. These criteria included qualifications and criminal history.



In 1993, a Commonwealth committee identified sub-agents as an occupation which was regulated in only some states and territories. As a result, the committee recommended abolition of sub-agent licensing. This recommendation was adopted by the Victoria Government in late 1994.

The act abolished sub-agents' licenses and reclassified sub-agents as agents' representatives. It transferred the responsibility for assessing a person's eligibility for employment as an agent's representative to the estate agent and also implemented a negative licensing system for agents' representatives.

Under this system, the Estate Agents Licensing Authority can apply to the Estate Agents Disciplinary Agents Tribunal to determine whether an agent's representative :

🚩 is eligible;

🚩 is of good character;

 has been found guilty of conduct unbecoming an agent's representative;
 has contravened or failed to comply with the act.

It is too early yet to assess the effectiveness of this negative licensing approach.

Conclusion and Recommendations

Is there a general rule-of-thumb for governments to follow in deciding which policy instruments to use when the need for intervention in the marketplace occurs? One decision-rule worth considering is the **Double Market Failure Test** recommended by D.L. Weimer and A.R. Vining¹. The approach ostensibly can be applied to good advantage at the national, state and local government levels. It is an approach, prior to considering government intervention, requires either that there be evidence of market failure or presentation and verification that a viable redistributive goal is in the offing. It requires too that there be reliable evidence that a less-intrusive government option cannot be utilized or, alternately, evidence must exist that an effective contract for private production cannot be designated for dealing with market failure. Under the Weimer-Vining ground rules, governmental intervention with market forces should not even be contemplated unless both of these conditions apply; moreover, the social goal(s) of governmental intervention must be presented and their worth verified before intervention should be contemplated as a viable alternative to business-as-usual..

Wilkinson's synopsis of Australia's use of alternatives to command and control regulation provides Florida government agencies with a potentially useful alternative to the program analysis process currently employed by most agencies. Characterized by an elegance and clarity of definition, design and functionality, the State of Florida would do well to apply the Wilkinsonian formulation, even if only experimentally, to test its potential contribution to improving policy outcome implementation.

Current definitions by OPPAGA of key PB² components are clear, concise and potentially useful if rigorously applied :

Program - A set of activities undertaken in accordance with a plan of action organized to realize identifiable goals and objectives based on legislative authorization.

Input - Monetary and nonmonetary resources expended for a service or product, such as staff time and salaries. The level of demand for services can also be considered an input.

Output - The actual service or product delivered by a state agency.

Outcome - An indicator of the actual impact or public benefit of a program.

Standard - The level of performance of an outcome or output.

Benchmark - A quantitative or qualitative indicator used to assess agency performance.

Whereas dedicated operationalization of the above PB² components by State government agencies is essential to the success of program outcome implementation, state government agencies have been dragging their feet in fully complying with OPPAGA

standards of performance in accordance with definitional criteria. Given their recalcitrance to fully operationalize PB², something must be done to improve current malpractices or else rectify current unrealistic expectations of what PB² is capable of achieving through the implementation of program outcomes.

It should be noted that the systemic components of PB² listed above are prescribed by the Legislature as well as being operationally defined by OPPAGA² as necessary, if not sufficient conditions, for fulfilling Performance-Based Program Budgeting's promise to implement program outcome. Florida TaxWatch recommends that they be operationalized by all State government agencies forthwith. Alternately, some hybrid application of Wilkinson's solution, perhaps working in tandem with a no-nonsense requirement by the Florida Legislature that government agencies adopt and rigorously apply the systemic components of PB² ought to be initiated.

Even if done experimentally, much would be learned about how to bridge the gap between the promise of PB² and the current flagging and unacceptable performance by many Florida State agencies in implementing program outcomes to the fullest extent possible. In any event, Florida TaxWatch will continue to promote these and other recommendations regarding how PB² should be implemented to the State's greatest advantage.

ENDNOTES

1. Weimer, D. L. & Vining, A. R. (1992). Policy analysis: Concepts and practice. Engelwood Cliffs, NJ: Prentice Hall.
2. Performance-Based Program budgeting and Justification Review Guide. (September, 1996) Tallahassee.

This *Briefings* was written by Geraldo Flowers, Askew School/ Florida TaxWatch Research Associate
and Mary Ruth Russell, Florida TaxWatch Assistant Research Analyst,
abstracted from a draft report Improving The Cost-Effectiveness of Government:
Alternatives to Command and Control Regulation by Dr. David Wilkinson, Graduate
School of Management and School of Business, LaTrobe University, Melbourne

Australia;
Edited by Dave Davis, Senior Research Analyst,
under the direction of Dr. Neil S. Crispo, Vice President for Research Development and
Dr. Keith G. Baker, Senior Vice President and Chief Operating Officer.
Joseph P. Lacher, Chairman; Dominic M. Calabro, President and Publisher.

© Copyright Florida TaxWatch, March 1999

For more information on this report, please call:

(850) 222-5052

OR

write Florida TaxWatch at:

P.O. Box 10209

Tallahassee, FL 32302