Market Failure: When Should Policymakers Act?

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(Note: presentation provided in personal capacity)

Rationale for Policy

Policymakers intervene in markets:

- To achieve social objectives
- To address market failures

- In mixed economies markets and governments are interdependent.
  - Policy decisions generally involve choices about the appropriate balance between imperfect markets and imperfect government policies.

Benefits of Markets

Advantages of Markets

- Well functioning competitive markets will provide significant benefits through greater choice, lower prices and better quality goods and services.

- Markets can provide stronger incentives for firms to be more efficient and innovative, thereby helping raise productivity growth.
  - Competition drives firms to reduce inefficiency and reduce costs

Market Failure

- With inadequate or inappropriate regulation, markets will not necessarily deliver the best outcomes for consumers, companies or Governments.
- ***Market Failure*** has a particular meaning in economics.
  - It refers to a situation where a market does not allocate resources efficiently.
  - That is, the market does not provide the goods and services demanded by consumers or does not provide them in the desired quantities.

Types of Market Failure

Public Goods

- Non-excludable, non-rival goods. Free rider problems.

Externalities

- Costs or benefits of production and/or consumption do not include the wider costs or benefits to third parties (society).

Information Problems

- When one party or both parties to a transaction have inadequate information to properly assess quality, price.
- Behavioural economics - new insights on role of information in markets

Market Power and Imperfect Competition

- Firms can increase prices beyond efficient level
- Firms can create barriers to entry

Market Failure - Well Recognised Policy Territory

Many policy interventions address market failure:

- The provision of national defence
- Controls over output of pollution
- Labelling of food
- Regulation of access to monopoly infrastructure

Policies can address market failure:

- ***Directly*** through the government as a market maker or as a supplier or buyer of goods and services
- ***Indirectly*** through policy instruments such as regulation, taxation, subsidies etc

Costs of Government Interventions

- Government interventions to address market failures can have negative consequences.

- Assessment of the costs of intervention is required (eg through regulatory impact statements)
  - However, this can become an exercise used to justify or dismiss a policy rather than genuine assessment. Difficult where there are diffused benefits vs concentrated costs.

- The policy choice will generally involve decisions about the appropriate balance between imperfect market forces and imperfect government policies.

Addressing Market Failure – Possible Impact on Competition

Does the policy intervention:

- Affect the potential for entry and/or exit in a market, by for example significantly raising the cost to new firms of entering?
- Affect the nature of competition between firms, either directly (eg price setting maximum prices) or indirectly by reducing the incentive for firms to compete?
- Affect the ability of consumers to shop around between firms and exercise choice though, for example, raising the costs of switching?

These are the sorts of issues that are formally addressed through ACCC's authorisation procedure, which asks whether benefits outweigh detriments.

Addressing market failures – do we need to reconsider?

- So ‘Market Failure’ is a long-standing policy issue, with some well-recognised policy responses.
  - But do we need to rethink any of these policy responses?
  - Is our “toolkit” appropriate for the task of addressing market failure?
- Behavioural economics is enriching our understanding of the behaviour of agents that may impact on our consideration of policies to address market problems.

An Example: Some Issues Around Information in Markets

- One widespread response to market failure in consumer markets in Australia has been additional information provision.

- It has become the ‘default position’ of policymakers in a wide range of settings

- ***But have we relied to heavily on information disclosure vs other policy tools? Is this approach always evidence - based?***

- ***What does information provision reveal about our understanding of market failure and our ability to be innovative in the policy sphere?***

Examples of Information Requirements to Address Market Failure

- Financial Services – product disclosure statements
- Telecommunications consumer codes (eg Mobile Premium Services)
- Food labelling
- Product Safety Warnings

and many more…

- Information can be mandatory (eg financial services disclosure) or voluntary (eg Australian Standard covering environmental claims).

- Use of information requirements also common in similar jurisdictions eg energy market in the UK following deregulation
  - However, Australia has arguably used information more broadly than comparable jurisdictions

Why Information Provision as Policy Tool?

Benefits of this approach:

- Information is vital for efficient markets.

- Market-enhancing, “light touch”, low cost, doesn’t inhibit consumer choice. A desirable approach to many market problems.

Two broad assumptions sit behind information provision policies:

- There is a shortage of information in the market
- Consumers use information optimally (rationally)

Shortcomings – Market Outcomes

Despite some apparent advantages, the shortcomings of information provision as a ‘catch-all’ policy response have become more apparent.

- Disclosure and information provision requirements have not reduced incidence of poor quality advice or poor market outcomes in some sectors eg financial services, telecommunications
- Consumer impacts:
  - Transfers risk to consumers (eg financial services)
  - Consumer confusion rather than better decision making
  - Disclosure information can be overwhelmed by other types of messages eg promotional (eg food industry?)
- Information requirements have imposed burdens on suppliers without improving market outcomes ie poorly targeted, not light touch

Shortcomings – Regulation and Policy

- In the policy sphere, information provision has resulted at times in a one-dimensional response to market problems, ‘crowding out’ other policy tools.

- For example, what has been the common response to weaknesses in information provision in financial services?
  - More disclosure, more studies of disclosure, more fine-tuning of disclosure requirements, rather than considering other tools.

- Why has this over-reliance on disclosure developed?
  - The provision of more information seems beneficial, no downside, low cost compared to “traditional” policy tools.
  - Reluctance to concede that consumers do not use information optimally ie to concede systemic consumer “irrationality.”

- The more critical questions are not asked. What is the nature of the market failure that disclosure is trying to address? What evidence do we have about the relative effectiveness of policy tools?

Limitations of Disclosure?

- Information disclosure is a vital tool in addressing market failure, but over-reliance has resulted in less effective regulation
- Findings from behavioural economics demonstrate that consumers in many situations do not use information optimally
- Disclosure has proven to be particularly problematic in dealing with conflicts of interest, especially in financial markets. (See Loewenstein et al *'Coming Clean But Playing Dirtier: The Shortcomings of Disclosure as a Solution to Conflicts of Interest'*).
- James Surowiecki argues that this is why disclosure is Wall St's preferred regulatory approach to conflicts of interest, as it allows firms 'to have their cake and eat it too'.
  - ASIC – major rethink of this issue in latest submission to Parliamentary Inquiry into Financial Services

Addressing Market Failures – Can We Do It Better?

- What does the experience with information provision tell us about reconsidering some of our policy tools and how we use them? How can we do this while limiting the impact on competition and choice?

- In particular, can we do better by considering a *combination* of tools to address market failure, rather than relying heavily on one policy tool?

- Some examples that go beyond traditional disclosure to address market problems that arise due to information deficiencies:
  - *Prohibiting* certain types of conflicts through regulating the relationship between supplier and adviser (eg Medicines Australia Code).
  - Limiting 'poor' information as well as providing more good information (eg limits of ads for prescription pharmaceuticals)
  - Simple mandatory standards for default products to reduce informational problems around choice (eg default standards have been suggested for compulsory superannuation).

Addressing Market Failure (cont)

Examples (continued):

- Look to policies designed to limit poor decisions arising from behavioural biases, but that don’t prevent choice eg New Mobile Premium Service Code
  - Double “opt-in”. *Two* positive signals required before purchase of premium mobile service takes place.
  - Call-Barring. The ability for the consumer (eg parent!) to bar expensive premium services from the mobile phone. Next question – should MPS be barred as a default or as active choice?
- Unfair Contract Terms to be prohibited under new consumer law – certain terms are unreasonable irrespective of disclosure
- Better design of information, based on consumer research and behavioural economics.
  - Example - emphasise losses as well as benefits (ads for debenture investments)

Conclusions - Market Failure: When Should Policymakers Act?

- Markets deliver very significant benefits to the community. Where possible our policies should facilitate efficient markets and competition.
- But markets don't always "produce the goods". Market failures are well recognised features of market economies.
- Have we seen, in some areas, an inflexible policy approach to market failure? In particular, do policies around information always take into account more recent thinking on the evidence of agent behaviour and the effect of policy tools?
- By using findings from research in areas such behavioural economics, as well as better *combinations* of policy tools, we can design more effective interventions.