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COMPETITION CAN CRUSH CRONY CORPORATISM

- The public trusts neither Big Government nor Big Businesses.
- A number of important consumer markets are suffering from a lack of competition.
- Cutting barriers to entry in banking, water, energy, transport is crucial.
- Competition in public sector procurement and supporting free trade also key.

1. INTRODUCTION

Competition is at the heart of what makes capitalism so effective at increasing prosperity. Companies which fear losing their customers to current or future rivals are forced to keep their prices lower and to raise the quality of their products. Equally, businesses must provide adequate wages and working conditions in order to attract and retain workers. In the absence of competitive pressures, businesses become lazy, complacent and wasteful. Innovation slows, prices rise and workers see deteriorating conditions. The free enterprise system cannot provide liberty and rising living standards if markets operate as cosy cartels without real competition or consumer choice.

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In recent years it seems that competitive pressures have diminished in a number of markets. The inevitable result is that consumers have become disillusioned about the benefits of big businesses. Polling undertaken last year which we published in The Road from Serfdom showed that roughly the same proportion of the population trust neither Big Government nor Big Companies (71% v 69%). An economy dominated by a big state operating alongside quasi-monopolistic big companies can deliver neither efficient nor equitable results.

Competition in the retail sector has seen supermarkets cut their prices and broaden their offerings for consumers – it is the perfect example for politicians to use when examining competition policy. It is therefore crucial that the next Government implements policies which will boost competition across a variety of sectors including banking, water, energy and transport.

All the main parties mentioned the word "competition" in their manifestos although not to the same extent or in the same way. The Conservatives mentioned competition six times and whilst Labour mentioned it seven times, three of those mentions were critical of it. In a document about twice the size of the other manifestos, the Liberal Democrats mentioned competition eight times; although two of those were critical. UKIP mentioned it twice and the Greens mentioned it just once in a promise to abolish competition in healthcare.

2. BANKING

When Metro Bank was set up in 2010, it was the first time in 150 years that a new company had been granted a banking licence. Many of the problems in the banking sector derive from a lack of transparency, choice and competition. The number of major UK banks fell to 22 in 2010 compared to 41 in 2000 and the Big Four (HSBC, Lloyds, RBS and Barclays) until recently maintained almost 80% of the retail banking market share. This concentration has increased the likelihood of banks that are too big to fail. Increasing retail banking competition would give consumers greater and better choice and drive banks to provide improved products and services. The new Current Account Switching Service reduced the time it takes to switch accounts to 7 days from between 18 and 30 days. This has seen an increase of 19% in switching in the first year of its introduction but still only 2.2% of current account holders actually switched. Cutting switching times is therefore important in empowering consumers.

Boosting banking sector competition should also entail reducing barriers to entry and easing the path to exit without causing systemic problems. Licencing laws should continue to be liberalised so that new entrants do not face onerous requirements. Challenger Banks such as Virgin Money, Tesco and others have the potential to radically improve the banking sector in a similar way that Aldi and Lidl have done in retail to the benefit of innovation and productive efficiency. This process has already begun with a sharp rise in the number of new banks.

The BBA estimates that it can be up to 8 times more expensive for a smaller bank to give someone a mortgage than for a bigger high street competitor. Some reporting and capital requirements on new, small banks should be eased to reduce the cost of maintaining a presence in the market. For example, new entrants are obliged to hold a minimum of £1 million in capital compared to £5 million in the past. Reducing the amount of capital required for certain loans would help to ease the process of entry. Allowing more flexibility in the risk weighting of loans could be done, for example, by allowing new banks to use averages of the bespoke weights used by big lenders. This would boost lending as well as the ability of Challenger banks to compete with existing market participants.

Challenger banks should also be able to share credit risk data. The big existing banks already have a lot of information on the credit risk of SMEs through access to current account performance data. This puts them at a distinct advantage to challenger banks who want to offer SME banking products. Allowing much greater flexibility in credit risk data sharing would therefore allow a more level playing field. In addition, local authorities should be allowed to use smaller banks, thereby opening a new market for Challengers. New banks should also not have to have a strong physical presence on the High Street especially when retail banking is increasingly done online and by mobile.

3. WATER

The water industry remains relatively insulated from competition with 19 regional monopolies providing our water. They collect the water from the source, treat it to an appropriate standard and send it to customers' taps via company-owned infrastructure. Rates are controlled by OfWat which is the independent regulator. Since privatisation in 1989, it is generally accepted that capital investment has seen substantial improvements. However, despite a recent cut in regulated prices, the chronic lack of competition has seen almost 50% real terms increases in water bills. In the Water Act 2014, the Government implemented some measures to increase upstream competition; for example, ending the requirement for upstream providers to provide retail services and vice versa.

Upstream competition has been limited because due to the method of calculating costs it has been difficult for licensees to earn sufficient profits to compete with the existing water companies. The result has been that the current water companies have felt little pressure to increase their efficiency. The Government should also aim to have a faster introduction of retail sector competition in the water industry than the current April 2017 target. Retail competition enables water companies to compete over the provision of services such as customer care, billing and meter reading. It is estimated these services comprise 10% of the total value of water delivered.

The Government also decided against letting incumbent water companies exit the non-household retail market. The main reason was that it could increase the cost of capital leading to higher water prices. Never mind "Too Big to Fail", the water companies are "Legally Forbidden to Fail". Indeed, the Government estimates that a 1% increase in the cost of capital would lead to a £20 increase in customer bills. The Government should nevertheless be aware of the longer term benefits to competition and innovation from allowing freer entry and exit and should therefore commit to re-examining the case for retail market exit.

The Government should also extend water industry competition to households. The Water Supply Licence regime has allowed some very limited competition but the reality is that extremely high consumption thresholds have restricted this to only the very largest of consumers. The ability to switch supplier remains restricted for the vast majority of consumers and thus acts as a major barrier to competition. Allowing companies, charities and the public sector ie all non-households, to switch suppliers will be a hugely liberalising step and help to exert real competitive pressures on price and quality. However, the Government should also give a commitment to extend this freedom to households as well. Non-household competition was introduced in Scotland in 2008 and the benefits have clearly been significant. More than 45,000 businesses have been able to renegotiate the terms of their contracts and substantial savings have been made through lower prices and lower water usage.

4. RAIL

As outlined in CPS paper Rail's Second Chance, the number of rail passengers has doubled since privatisation and will probably have quadrupled by 2030. There are now more rail passengers but half the track size compared to 1929. However, the public subsidy for rail operators has increased and ticket prices are some of the highest in Europe. In reality rail has seen privatisation without competition. Franchised rail operators effectively monopolise the key long distance routes which severely inhibits any meaningful competition.

Nevertheless, in rail freight for example we can see the substantial benefits of competition. Rail freight, which has been subject to competition, has seen strong investment, strong productivity growth and a 35% cut in unit costs in the 10 years to 2008/9. On the other hand, passenger operators experienced a dismal 10% increase in unit costs. Furthermore, competition on the East Coast Main Line between Grand Central and First Hull Trains has led to more journeys, higher revenues for train companies, lower fares and happier passengers. Encouraging greater competition between rail operators would therefore lead to lower prices, better service and generally more efficient infrastructure.

5. ENERGY

The energy market requires substantial pro-competition reforms. A key problem is the very low level of switching between suppliers. With the vast majority of consumers never changing their existing suppliers, it effectively means that only a small proportion of the market is subject to competitive pressures. If more households began to switch suppliers to get a better deal, then energy firms would face an increasing incentive to compete, improve service and keep prices lower to maintain their existing customers.

The key reasons for consumers not switching are that complicated billing makes effective comparison with competitors very arduous. This compounds the feeling that the hassle and time it would take to switch is not worth the potential savings. Consumers may also believe switching to be fruitless if competitors shortly raise their prices anyway. The number of energy suppliers has increased and switching times have fallen but more progress can be made. The CPS will soon publish our more detailed proposals to reform the energy market.

6. PUBLIC SECTOR

The Government should build on the progress of the Government Digital Service (GDS) in helping SMEs compete in public sector IT procurement. The GDS has undertaken an impressive set of reforms to increase the efficiency, flexibility and openness of the British state. When the Government came to office, approximately 6.5% of the procurement budget was spent directly on SMEs; this increased to 10.5% of the budget in 2013/14. The Government has also promoted greater transparency such as publishing the details of contracts worth over £10,000 online. There has also been a simplification of the pre-qualification procedure for procurement. Furthermore, the GDS has opened public sector procurement to SMEs which has led to increased competition. IT contracts have been broken into smaller more cost-effective structures and new break-in points over the course of project completion have added greater cost control.

The Government should continue with this progress in opening up public sector procurement to SMEs and especially to reach the 25% budget target and higher. On the specific issue of public sector IT procurement, the Government should build on new ideas to promote competition such as a cap on the size of IT projects, alongside a ban on automatic contract extensions and an end to new hosting contracts lasting more than two years. It is vital that the public sector procurement is not allowed to become a closed shop with big, well known providers gaining a competitive advantage over newer entrants.

The creation of the EU wide single market in public sector procurement offers British businesses significant opportunities to new gain contracts across the EU. Not only does this mean greater exports but it also means that British businesses will compete against many more firms across the continent for contracts. This will increase their productive efficiency as well as potentially giving them new ideas for how to expand or improve the services that they provide. The EU public sector procurement market for services such as healthcare, social care and education is estimated to be worth £450 billion. The development of this single market also means a much faster, streamlined process for Governments looking to outsource as well as the introduction of a form of blacklisting of firms providing significantly or persistently deficient services. The new rules are to be introduced across the EU in the coming years and in the meantime the Government should ensure that all firms involved in domestic procurement processes are fully aware of the upcoming opportunities.

In the medium term, the Government should also push for a lower contract value above which EU public sector procurement will be subject to continent-wide competition. Contracts worth less than €750,000 will not be subject to the same competition because they will not be required to advertise in the EU contracts journal to inform competitors across the continent of the new opportunities. This reduces the benefit for some SMEs who may be used to providing higher volume but lower value contracts. In order to increase competition and open up new services export markets, the Government should push for the threshold to be lowered.

7. FREE TRADE

The Transatlantic Trade and Investment Partnership is the proposed free-trade agreement between the USA and the EU. The proposal would considerably increase the number of traded goods facing zero-tariffs as well as reduce non-tariff barriers. The EU and the USA combined are approximately half of the world's output and a third of the world's trade and so the opportunities for a significant boost to trade and productivity growth are clear. The Trade in Services Agreement is a multilateral negotiation which if agreed would help to improve and expand trade in services amongst countries which count for 70% of the World's trade in services. Whilst they are not perfect, if they are finalised and agreed, both of these would substantially help drive UK productivity growth and boost competition across a variety of markets. The Government should therefore oppose any attempts to slow or derail the agreements.

The Government should also push for a reduction and simplification of EU tariffs on fast growing economies. The benefits of increasing openness to global trade are well known. However, barriers to trade with fast growing non-EU countries remain an impediment to UK exports. Trade disputes with China on solar panels, chemicals and technology products have highlighted the need for a simplification of EU trade rules with non-EU countries and much stronger advocacy for free trade. EU "trade defence" rules still impact 0.25% of imports. Whilst this situation is better than other trade zones, the Government should still push EU institutions to reduce and simplify tariffs to promote trade and competition with fast growing economies.

8. CONCLUSION

Much of the attention during this election campaign is understandably focussed on fiscal policy. However, it is vital that the next Government also implements a series of refreshed competition policies. Not only will this drive up Britain's weak productivity performance but it will help to reclaim popular capitalism from the crony corporatists.

9. MUST BE READ:

Lord Saatchi: We need true popular capitalism to bust the cartels
Dominic Raab: We need a second wave of the consumer revolution

10. MUST BE READ ON CAPX:

Declan Ganley & Brian Carney: It's time to break up the telecoms cartel
Philippe Legrain: The future of globalisation is in doubt

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