The Competitive Fantasy

ANGUS SIBLEY

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Peter Turvey, in a recent letter to *The Actuary*, recalls the joint share-buying initiative by City of London institutions which ended the fearsome 1972-75 bear market. For us older investors, that period is a vivid and painful memory. I was then working for an Edinburgh stockbroking partnership. I recall one murky afternoon in November 1974 when, just after market closing, our senior dealer showed me the firm's dealing ledger, a hidebound manuscript tome. For that grim day, a virgin page recorded not one single bargain.

As Turvey observes, a collusive market operation like that of January 1975 would today be a criminal offence. Why, he asks, is *an action which 30 years ago was the hallmark of a leader… now the stigma of a scoundrel?*

He poses a fascinating and wide-ranging question. Why are we obsessed by the desire to suppress almost any collaboration between commercial or professional rivals? This attitude is not new; we find it in Adam Smith, who objected to the existence of a register of the tradesmen in a town, since this *connects individuals who might otherwise never be known to each other, and gives every man of the trade a direction to find any other man of it.*[1]

Smith thus envisaged the possibility that there could be, shall we say, a dozen independent bakers in Edinburgh who did not know of each others' existence, and so could not meet to form a shameful cartel.

But if even the bakers did not know where the bakers were, how could their customers know? How could there be a Smithian efficient market in baps and butteries? Let this be a reminder to us that even the greatest economists can, and do, write nonsense.

Needless to say, the main reason for our horror of collusion between competitors is that it may well lead to restraint on their competition. Today's fashionable mantra is that any such restraint is intrinsically wrong; that we need not merely competition, but the fiercest possible competition, whether or not it is "fair"; this, of course, includes unlimited international free trade. Milton Friedman is on record as saying that *the more unfair the competition, the better.*[2]

Competition in moderation

That, surely, is another example of a famous economist talking nonsense. In how many good things can we overindulge without harm? Scotch malt whisky is an excellent drink; should we drink as much of it as possible? In the *Journal of the Royal Society of Medicine* (June 1995) I have argued that competition plays a role in the economy like that of the thyroid hormones in the human body, which stimulate metabolism and growth. These hormones, though vitally necessary, can be fatal when present in excess.[3]

Not so long ago, moderation of competitive pressures was generally thought acceptable and desirable. In *A History of British Insurance* (1964) Harold Raynes, then chief actuary at Legal & General, wrote that *various bonds between insurers and groups of insurers…are conducive to, and indeed necessary for, the health of the industry. There is competition in the market, but it is an ordered competition with rules of conduct to which members feel themselves obliged to conform.* Reading those words today is like listening to Melba on a mechanical gramophone with a brass horn. One feels transported into a bygone age.

Must we accept that Raynes's moderation is as dated as the 78 rpm disc? Recent experience has thrown up many examples of the downside of untrammelled competition. A basic problem is that, when competition squeezes profit margins, firms are driven to compensate by selling greater volumes. In life and pensions, this has meant huge mis-selling of unsuitable products. In banking, excessive lending has brought us painful personal debts in advanced economies and crippling national debts in the third world. In consumer goods, the same principle floods us with superfluous trash, implying waste of natural resources, surfeit of discarded rubbish, and needless harm to the environment.

In investment banking, deregulated commission rates no longer cover research costs. So research is now paid for largely by share-issuing companies rather than by share-buying investors. I need not remind you of the recent consequences.

Pandering to consumers, squeezing producers

Governments' obsessions with competition are seemingly based on the curious belief that we consumers vote, while we producers (workers) do not; so economic policy must pander to us consumers by squeezing us producers. It must ensure that ruthless competition ceaselessly prunes costs and prices. It forgets that one person's costs are another's wages. With less competition on price, businesses would compete more on quality of product and service, thus expanding employment.

But the view that competition always cuts costs is wrong anyway. It can inflate them. The end of uniform commission rates allowed life insurance offices to boost their sales by paying higher commissions to brokers; but this practice inflated the insurers' costs. The death of "gentlemanly capitalism", in which rival firms did not poach each others' staff, has propelled the rewards of ace performers to grotesque levels. We are immersed in a winner-takes-all society with excessive stresses, gaping inequalities and too many losers. In the 1960s it seemed that advanced economies were putting the two-nations syndrome behind them. The free-market zealots have deliberately pushed us back, in this respect, towards the nineteenth century.

Another of their arguments is that, if competition is restrained by law or custom or agreement, then it may reappear in underhand forms. When Stock Exchange commission rates were fixed, it was not unknown for certain brokers to undercut their rivals by charging the correct commission on the contract note while discreetly handing the client a "brown envelope", in France more pleasingly called a *pot-de-vin*. Current neo-puritan opinion, in righteous indignation, holds that untrammelled competition will cleanse us from such sins by removing their motive.

Yet free competition is not as clean as its proponents imagine. It has its own kinds of dirt. One is the promotion by agents of what pays the fattest commission, rather than what is best for the client. Another is flagrant undercutting with intent to eliminate competitors. In French retailing, resale at a loss is expressly forbidden by the *loi Galland* of 1996, a controversial measure that free-marketeers would gladly repeal.

The murky task of competition enforcement

Enforcing the rule that businesses must not collude is a difficult and unsavoury task. Britain's Enterprise Act 2002 empowers the Office of Fair Trading to use intrusive surveillance, undercover agents and "bugs" to smoke out miscreants. "Dawn raids" on company offices are now frequent in America and Europe. Employees are encouraged to inform on their employers' anti-competitive behaviour. According to legal academic Alan Riley, *there are…conflicts between the European Commission's competition investigation and contentious procedures and the case law of the European Convention on Human Rights* (3).

In theory, unlimited competition should squeeze profit margins to wafers. Happily, many businesses contrive to avoid that fate. For there are, in practice, various escape routes. One is cost-cutting, but this is no long-term solution; if you can cut your costs, so can your rivals; in the end you are no better off. Another is excessive product complexity, making comparison difficult for consumers; hardly a benefit for them. Another is familiar to any user of an electronic printer: the machine is cheap, but on one estimate the price of ink is £1,400 the litre.

Yet another is innovation. You can earn good margins on a new product until your competitors see their way to copying it. But technology ensures that the profitable life-cycle of new products grows ever shorter, so innovation's effectiveness depends on its continual acceleration. In other words, an ever faster pace of change; probably not what most of us want. Indeed, economists never stop grumbling about popular unwillingness to accept more rapid change. They remain determined to ram it down our throats. Is this democracy?

Game theory

Businesses can, in fact, collude without meeting, writing or talking. Game theory explains how rival firms can signal to each other by their pricing actions that they see certain price levels as minima, that any undercutting of these levels will bring retaliation, sparking a price war with casualties all round. In theory, such "tacit collusion" is illegal; but since it leaves no trail it is *likely to be unactionable as a matter of law*, as admits an American submission to the OECD.

It seems, then, that restraint of competition will always be with us; but also that is not always the unpardonable sin that free-marketeers say it is. Perfect competition is a theoretical fantasy which we cannot achieve in practice; and that is fortunate, for we would hardly enjoy living with it. A degree of restraint is necessary for civilised economic life.

Without their current paranoia, governments would design better competition policies. What about the principle that restraint is acceptable, provided it is moderate and above-board? In Britain, until 1973, the Department of Trade and Industry maintained a Register of Restrictive Trading Practices to keep agreed restrictions on public record. Surely that was a saner strategy than our indiscriminate outlawing of such agreements, our struggles to eradicate what is both ineradicable and potentially useful.

[1] Adam Smith, *The Wealth of Nations*, book I, ch. 10, part 2.
[2] Friedman made this comment in the second episode of his TV series *Free to Choose* (1980). A transcript can be viewed on TheDailyHatch.org.
[3] Article reproduced on this site.