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Do we still need to regulate telephone services?

Appendix 1

Competition, regulation and the CRTC

Between the publication of Adam Smith's *The Wealth of Nations* in 1776 and the late 19th century, economists viewed competition mainly as a process of rivalry, held in check by market regulations set out in common law (respect for property rights and freedom to make contracts). The only condition attached to the existence of competition was something simple for public authorities to observe, namely that businesses remain legally free to enter into any industry and benefit from abnormal profits (in other words, yields above what is usual for a comparable level of risk). Monopolies represented situations where regulatory barriers artificially hindered this free entry without regard to the number of businesses (one or many) in the industry at stake.

However, starting in the late 19th century, the concept of "pure and perfect" competition exerted a strong influence on economic thought. Competition was no longer a matter of a dynamic process of rivalry but rather a condition in which, among other factors, there should be so many minor competitors that none among them could influence prices. Given the completely unrealistic character of pure and perfect competition and the fact that no economic sector met its requirements, governments attempted to bring the economy closer to this ideal by creating a substantial regulatory burden (antitrust laws) that remains in place to this day.

In the last few decades, this ideal of pure and perfect competition and the need for governments to impose it have been under attack in modern economic analysis. Its unrealistic nature and its contradictions have been raised by economists such as Friedrich Hayek (winner of the 1974 Nobel Prize in economics) and Joseph Schumpeter. Competition is not an end-state but an Adam Smith-style process in which entrepreneurs must bet on the future and make risky investments. Normal functioning of this process could lead to concentration in a given industry and limit short-term gains for consumers while further increasing them in the medium and long terms, thanks in particular to investment in new technology or infrastructure. This would result in the market being better equipped than government bodies to determine the degree of concentration serving the best interests of consumers.

Moreover, the degree of concentration observed by the regulatory system depends on how the industry or sector in question is defined. In technocratic jargon, a "market" (or a good) is defined in terms of substitution (or more precisely in terms of "cross elasticity of substitution"). When two economic goods are close substitutes for consumers, they are considered part of the same "market" (or sector). On the other hand, public authorities view them as two distinct "markets." Where exactly to draw the line remains arbitrary: the criterion of substitution depends heavily on the subjective needs of consumers. Thus, two goods may be substitutes for some consumers but not for others; they may also be substitutes for individual consumers in certain situations at particular moments but not in other situations.

Even in an industry where the number of competitors is limited, what counts is potential competition. This competition may come from new entrants to the sector or from companies offering similar products or providing a similar type of service but in “other” sectors of the economy.

In fact, true monopolies benefit from legal protection, when they are not simply government-owned corporations. It is when governments prohibit free entry to a particular industry that a true monopoly, such as Hydro Québec or Canada Post, manages to survive.

Regulation of competition creates its own substantial costs. The widespread belief that regulation benefits consumers by protecting and controlling so-called “natural” monopolies or by trying to correct other “market failures” has not stood up to contemporary economic criticism. First of all, this hypothesis does not explain why nearly all industries are regulated, regardless of whether “market failures” are a factor. In addition, companies themselves very often initiate and support the regulatory system to which they are subjected (for example, AT&T initiated and defended telephone regulation in the United States). Rather than protect competition, this type of regulation ends up protecting monopolies against their potential competitors.

The economic theory of regulation developed by George Stigler, winner of the 1982 Nobel Prize in economics, explains that the authorities, whatever their regulatory aims may be, find themselves being “captured” by the interest groups that are supposed to be regulated.

In a more general sense, the theory of “Public Choice” inspired by James Buchanan, winner of the 1986 Nobel prize in economics, explains the growing proliferation of regulation by what economists call “rent seeking,” in other words quests for privileges and redistribution. The winners in these quests are usually well organized lobbies such as large corporations or powerful trade unions. Government bureaucrats also engage in rent seeking of their own through efforts to improve their remuneration and the benefits attached to their positions.

Rent seeking engenders costs for all sides: the winners obtain less than what is taken from the losers. The reason for this is a process that swallows real resources – the time involved in lobbying, computers to prepare briefs or build websites, etc.

The theory of Public Choice suggests that regulation, as determined by political and bureaucratic processes, fails to satisfy public needs and instead serves private interests that, at given moments, control the legislative agenda and the orientations of regulatory authorities such as the CRTC. The intensive lobbying generated by the CRTC’s regulatory power offers reason to believe that a large proportion of the “rents” obtained by privileged companies and groups is squandered in the fight to obtain them. The cost of CRTC regulation is seemingly very high, wasting economic resources that could be better used in satisfying Canadians’ needs.