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## **Corporate collapses and deregulatory dilemmas**

Over the last year or so, Australia has seen a series of corporate collapses unparalleled since the recession of 1989-92. Notable failures have included those of, the retailer Harris Scarfe, HIH Insurance, telecommunications companies include OneTel, and, most recently, Ansett Airlines.

Some of these failures, such as that of Harris Scarfe, reflect the ordinary operations of the market, in which bankruptcy is the penalty for bad management and bad luck. Others, such as that of HIH reflect the breakdown of prudential regulation resulting from the waves of financial deregulation that have taken place in Australia since the 1980s, and may be seen as an echo of the 'entrepreneurial' boom and bust of the 1980s.

More interesting cases are those in which formerly regulated markets such as airlines and telecommunications have been 'opened up', with the promise that competition will produce lower prices and improved service. These policy initiatives have gone under a variety of names including deregulation, liberalisation and microeconomic reform. In recent Australian discussion, however, they have been referred to generically as 'competition policy'.

To some extent, although not as much as is commonly claimed, the promises of competition policy have been fulfilled in recent years. For example, although standard airfares rose following the end of the two airline policies, discount fares became more widely available, particularly in periods when new entrants challenged the incumbent duopolists. Similarly, the price of most telecommunications services (apart from line rental) has declined, but only at the same rate as took place before deregulation. Moreover, for most consumers, the main factor controlling prices was not competition, but the regulations which require annual reductions in the price of Telstra's services.

Following the collapse of Ansett, Qantas has greatly reduced the availability of

discount fares. Similarly, Telstra has expressed confidence that the failure of OneTel will lead its competitors to take a less aggressive approach in future, and reduce the pressure on its profit margins.

Obviously, these failures raise questions about competition policy. On the one hand, as noted above, a central assumption of competition policy is that firms should be allowed to fail, and their employees and managers subjected to the 'market discipline' of bankruptcy or takeover. On the other hand, an outcome in which a single firm dominates 70 or 80 per cent of the market scarcely seems to accord with ordinary notions of competition.

To understand the dilemmas of competition policy, it is necessary to understand the world view that has driven the formulation of competition policy in Australia, and the extent to which this view corresponds (or fails to correspond) to reality.

Competition policy would be unnecessary in a world where all industries were like wheatfarming, consisting of thousands of small enterprises, none of which is large enough to affect the prices and conditions under which wheat is traded. On the other hand, if the benefits of size were so great that the optimal system of economic organisation was to have all goods and services produced by a single enterprise, competition policy would be irrelevant. The policy choice would be simple: public monopoly or private monopoly.

The ideal world for competition policy is one in which, for many industries, the 'natural' market equilibrium under appropriate rules is a market in which a number of large firms (say between three and ten) compete vigorously, possibly accompanied by a 'fringe' of small firms filling minor market niches. In these circumstances, the job of the competition regulator is to set and enforce rules which will prevent one firm from unfairly achieving and exploiting market dominance, or a group of firms from colluding to exploit consumers. Mergers between firms must be scrutinised to ensure that anti-competitive effects are minimised. The outcome is sometimes referred to as 'workable competition', a vague term which has been defined as 'a degree of competition considered

acceptable by the economist calling it “workable””. In the Australian context, markets with three or more participants have generally been regarded as displaying ‘workable competition’.

Competition policy in Australia is organised on the basis of an implicit assumption that these ideal conditions apply to the markets in which most large enterprises operate. Special treatment is provided for a small number of ‘natural monopolies’, in which a single firm is dominant. Natural monopoly is assumed to arise from the existence of an ‘essential facility’, such as an electricity distribution network or a local telephone network, which cannot economically be duplicated. A set of special policies, including requirements to allow third-party access to infrastructure and restrictions on ownership of ‘upstream’ and ‘downstream’ businesses (in the electricity case, generation is ‘upstream’ and retailing is ‘downstream’) have been introduced to deal with natural monopolies based on essential facilities. These policies have their own difficulties, but they represent a broadly coherent response to the problem of natural monopoly.

The hard cases for competition policy arise in industries where there is no obvious essential facility, but where the economies arising from large-scale operation are nevertheless so extensive that the market cannot support more than a handful of competitors (supplemented in some cases by a ‘fringe’ of niche suppliers). Examples in Australia include airlines, banking, brewing, many areas of retailing, and those parts of telecommunications that are not natural monopolies, including long-distance and mobile telephony.

In industries of this kind, the more vigorous and unfettered the competition, the greater the danger that a single firm will come to dominate the market. Hence, policymakers must choose between a policy which is aimed at protecting the weaker firms, and thereby preserving competition in the long run or one which is aimed at maximising competitive pressure on prices in the short run, with the risk that monopoly or near-monopoly will result.

Over the last two decades, Australian policymakers have dealt with this problem primarily by wishing it out of existence. A number of comforting illusions have been nourished. Perhaps the most popular is the belief that changes in technology, associated with the development of the microcomputer, have rendered notions of size economies and natural monopoly obsolete or at least less important.

The most ludicrous manifestation of this belief was the set of policies which encouraged Telstra and Optus to lay parallel sets of coaxial cables down the streets of Sydney and Melbourne in a bid to encourage competition in the pay-TV and local telephone industries. The outcome, obvious in advance to anyone not blinded by ideology, was that half the country got two sets of redundant cables, while the other half got none. In an interesting piece of symbolism, the cable rollouts were halted on July 1 1997, the day that the telecommunications market was 'opened up to full competition'. Neither rollout has gone any further.

Leaving aside such obvious silliness, the idea that small computers would be favorable to small companies seemed intuitively plausible, but has proved highly disappointing. The personal computer software and hardware (that is, microcomputer chip) markets have been almost completely monopolised by Microsoft and Intel respectively. Microsoft inheriting the old IBM monopoly broken up by the US Department of Justice. The wave of small companies started up in the Internet boom of the late 1990s represent, in retrospect, the froth of a market bubble rather than the harbingers of doom for corporate dinosaurs.

The second major illusion arises from the idea of 'contestability', which holds that the threat of competition can be as powerful as competition itself in constraining monopoly pricing. The originators of this idea, American economists William Baumol and Robert Willig, promoted it with some enthusiasm in the early 1980s, but were subsequently dismayed by its uncritical use, pointing out that the theory of contestability only applies under stringent conditions. In particular, it requires that entrants to an industry should be able to leave the industry without incurring large losses.

Because planes are ‘capital with wings’, Baumol and Willig thought their analysis would apply to airlines, and the early experience of deregulation in the United States appeared to bear them out. However, subsequent experience in the United States and Australia has shown that the establishment of an airline requires substantial, irretrievable investments in airport landing rights, terminal facilities, maintenance facilities and so on. Nearly all of the hundreds of entrants to the US airline industry subsequently left, but not by flying off to another market. The only exit routes have been bankruptcy and acquisition, commonly at firesale prices.

The same has been true in Australia. Many firms have entered the Australian airline industry, and all but Qantas and Virgin have left through bankruptcy or merger. Virgin may appear to be the exception that proves (the word ‘proves’ here means ‘tests’) the rule. However, Virgin’s assault on the Australian market must be seen primarily as a strategic move, motivated by Virgin’s cross-ownership with other players such as Singapore Airlines and by the desire to hit back at British Airways, the effective owner of Qantas and Virgin’s main competitor on the North Atlantic route (Richard Branson always refers to his opposition, correctly, as Qantas-BA). If operating profit alone were the driving force, Virgin would never have set up shop in Australia.

The final piece of wishful thinking is an overly optimistic assessment of the competitive pressure exerted by niche operators in markets otherwise dominated by one or two large players. One problem that arises in regulated industries such as telecommunications is that many niche players are simply engaged in arbitrage — buying services from the dominant players at cheap regulated prices, and reselling them at a price that undercuts those of the dominant player. Such a possibility exacerbates the inherent difficulties of regulating the prices of dominant firms. More generally, as we have seen with the competition to banks provided by mortgage brokers, dominant firms may simply restructure their prices to extract monopoly profits in segments of the market where entry by niche operators is more difficult.

There is no easy answer to the problems of monopoly and competition, but some observations can be made. First, many of the arguments for privatisation of government business enterprises have relied heavily on the kind of wishful thinking about competition that has been exposed as illusory in the last year. Unless governments are willing to accept the likelihood of an enduring private monopoly, usually foreign-owned, they should be more cautious about privatisation than they have been in the past.

Second, once competition has been replaced by monopoly, as it has been in the case of airlines, the standard mechanisms of Australian competition policy, represented by the Trade Practices Act, are totally inadequate. A full-scale regime incorporating detailed regulation of prices and services, similar to that applying to Telstra's core telecommunications services, is required.