

TRANSFORMING COMPETITION POLICY: OPTIMIZATION AS THE PRIMARY GOAL

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〈Abstract〉

Murray B. Stanley, 2013. **TRANSFORMING COMPETITION POLICY: OPTIMIZATION AS THE PRIMARY GOAL**, *Journal of International Studies* 20. In recent years, microeconomic reform in many Western countries has led to an increase in industry competition. This is based on the belief that competition is the best means of lowering prices, improving choices for consumers, encouraging innovation and providing an environment for more efficient and productive business. The effectiveness of this approach has not been thoroughly examined. The terminology associated with the reforms is emotionally and intuitively appealing. It implies that any increase in competition is 'good' for the consumer. This approach does not stand up to closer scrutiny. In some industries the results have included higher prices and decline in quality. Other problems like lack of investment in research, development and infrastructure are less obvious impacts. The late W. Edwards Deming argued that a more intelligent approach to managing competition policy was required. This paper supports that argument by examining specific industry examples. Under the new approach outlined in this paper, the aim of competition policy would switch from 'increasing competition' to optimization. It is this new approach that will receive attention in this paper.

Key words: Competition, Policy, Transforming, Optimization, Deming

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I. Aim

The aim of this paper is transformation of competition policy. For this to occur, the current competition legislation that exists in places like the United States of America, the European Union, Australia, Canada and New Zealand must be reviewed and replaced. This transformation is not a job of reconstruction, nor is it revision. It requires a whole new structure from foundation upward. This paper aims to supply that structure. The paper will also show why this transformation is urgently required. It will examine several international industry examples and show why optimization must be the new aim of competition policy.

A new approach to competition policy - optimization as the goal.

The current focus of competition legislation is overwhelmingly weighted towards increasing competition wherever possible. Dr Deming warned against this approach, "How many years will pass before government regulatory agencies learn that the forces of competition for price do not solve the problems of quality and of service: that competition that destroys service may not be a desirable aim of regulation? Two decades? Three? Regulatory agencies, victims of mandates that are not clear, or are outdated, not knowing how to take into account the interest of the public, may meanwhile continue to make it difficult for industry to improve productivity."¹⁾

Under the new approach proposed in this paper, prices are just one factor in a systematic and methodical approach to managing industries for

1) Deming, W.E. (1982). *"Out of the Crisis"*. MIT Press.

optimization. This approach can be represented in the diagram below.



Figure 1: Optimization as the primary goal. (Diagram by Jesse Smith)

Why new competition policy is needed urgently

Current competition policy has failed because it rarely takes into consideration the unique aspects of each industry and ignores the issues of quality and optimization. This can result in increased prices, good suppliers going out of business or forcing a good supplier to lower the quality of their product to remain competitive on purchase price. An example is the air service in the United States. “Anyone would agree with me, I think, that our air service in the United States is deplorable. An example of what is predictable from deregulation, competition and open entry. Can it be worse? Wait a month.”²⁾

2) Deming, W.E. (1994). *“The New Economics for Industry, Government, Education”*, 2nd Ed., Cambridge: M.I.T. Center for Advanced Engineering Study.

The former Chairman of American Airlines stated, "The consequences of deregulation have been very adverse. Our airlines, once world leaders, are now laggards in every category, including fleet age, service quality and international reputation. Fewer and fewer flights are on time. Airport congestion has become a staple of late-night comedy shows. An even higher percentage of bags are lost or misplaced. Last-minute seats are harder and harder to find. Passenger complaints have skyrocketed. Airline service, by any standard, has become unacceptable."³⁾

The air service in the United States was deregulated under the Airline Deregulation Act(1978). This resulted in a dramatic increase in competition, but it also caused a decline in the quality of the service. Intense competition may have forced the price of air tickets lower, but lower prices forced airlines into making losses or very slim profits. Airlines require massive capital expenditure to purchase new aircraft fleets and associated systems. As a result of intense competition, many airlines in the United States had insufficient money to update their aircraft fleets. The result - air travelers and society lose.

The air service in the United States is just one example of an industry that has been damaged by poor competition policy. Customers in other industries have suffered due to duplication, waste, declines in service, increased prices and a lack of standardization. Opportunities lost due to a lack of research and development are less obvious yet equally important.

3) McGee, B. (March 2008). *"Why airline reregulation is no longer taboo"*. USA Today.

Competition policy that currently exists in many countries can be represented by figure 2 below. Its goal is not optimization, but instead, increasing competition wherever possible. Purchase price is given priority but important factors like quality, social factors, encouraging cooperation between competitors and other organizations, and externalities like the environment are ignored or only partly taken into consideration. Decisions on ownership are often considered separately on political grounds instead of as part of a systematic decision making process.



Figure 2: Popular competition policy as practiced. (Diagram by Jesse Smith)

The letter from the former Australian Government in Annex A outlines the country's approach. It is similar to the approaches used by other Western countries like Canada and the USA. Unfortunately this approach is based on ideology instead of rigorous study and analysis of industries. The consequences have included high prices and a decline in quality within some industries.

An example of where this has occurred is the retail electricity market in South East Queensland, Australia. The diagram in Annex B shows that electricity prices increased dramatically in Brisbane, Australia when competition went from one retailer to eleven in 2007. In the four years after competition was introduced, electricity prices rose by an average of twelve percent per annum. In the six years prior to competition, prices increased by an average of three and a half percent per annum. Prior to July 2007, electricity was supplied by a single retailer. Since the introduction of competition, consumers have received saturation marketing coverage from telemarketers and door to door salespeople trying to sell their product.

In a competitive environment electricity retailers must spend large amounts of money on acquiring and retaining customers. Monopoly retailers can however keep marketing costs low because they have no one to compete against. Although marketing costs represent a portion of these price increases, eleven retailers would operate at a higher cost than one of them alone as a monopoly. Electricity prices would be higher due to these increased marketing costs.

The importance of monopolies and accurately determining the appropriate level of competition was clearly understood by the Australian economist, Steve Keen. "The main danger of economic theory in this area is that it will encourage the dismemberment of existing monopolies for no good reason, or the use of competitive approaches to the provision of public services when a concerted monopoly approach would be superior."⁴⁾ This critical point was not understood by some

4) Keen, S. (2001) *"Debunking Economics"*. Pluto Press Australia Ltd.

Australian politicians.

“Australia’s competitive roll out of optical cable, in which two suppliers competed to provide physical cable links to households and firms led to the richly and densely populated parts of the country having two optical cables running past every house while poorer less densely populated areas had none. This disparity has widened as many new suppliers provide optical links in and between major cities, ignoring the unprofitable country towns, homesteads, and even wealthy ‘large estate’ regions of major cities.

New forms of technology have ameliorated the damage, by providing other means by which those not connected to optical fibre can have high speed telecommunications. But the end result of following a competitive approach has been that far too much has been spent on providing Australia’s telecommunication network, and telephone and internet access prices have been kept artificially high to finance this waste.”⁵⁾

Another example of waste and inefficiency caused by competition was reported in the Wall Street Journal - “One of the established hospitals in Fort Wayne, Indiana, opened a new modern building at a cost of \$91 million. The two other hospitals in the town tried to keep up and remain “competitive”. They remodeled and refurbished. Each attempted to increase its market share at the expense of the other. But the three hospitals already had enough capacity. The vacancy rates of the three range from 47 percent to 77 percent. Each hospital has excess capacity,

5) Ibid.

which raises their average costs per patient. Patients, then, must pay higher fees than they would if the hospitals cooperated. Three hospitals offer high-technology medical services in an area where the community would be just as well served by one or two hospitals.” By cooperating and avoiding duplicate services, the hospitals could lower patient costs, lower interest costs for new construction, and operate their hospitals more efficiently.⁶⁾

Despite the problems caused by competition, it is extremely popular with Western governments, competition authorities and some economists. It is often perceived to have several advantages.

The advantages of competition

The effectiveness of competition as a means of lowering prices, improving choices and providing an environment for increasing innovation is rarely challenged. Alfred Kahn once stated “Whenever competition is feasible, it is, for all its imperfections, superior to regulation as a means of serving the public interests.”⁷⁾

Underlying this proposition “is the belief that firms have the strongest incentives to give customers what they want in terms of price and quality of service when they are in competition. In such circumstances, firms also have a strong incentive to gain a temporary advantage over their rivals through innovation and the development of new services. Compared with this scenario, the regulation of monopoly that faces no

6) Aguayo, R. (1991). *“Dr Deming, The American Who Taught the Japanese About Quality”*. Fireside.

7) Dudley, S.E. and Brito, J. (2012). Quotation attributed to Alfred Kahn in *“Regulation: a Primer”*. Mercatus Center at George Mason University.

competition has many disadvantages. A monopoly is under very limited pressure to produce services which meet customers' needs.”⁸⁾

The most commonly perceived benefits of competition will now be scrutinized.

a. Reducing prices.

In some industries the introduction of competition has driven down purchase price, but “price” is more complicated than purchase price. “Price has no meaning without a measure of the quality being purchased.”⁹⁾ An example is to consider two products.

Washing machine A's purchase price is \$400 and washing machine B's is \$500. Machine A's purchase price is \$100 less but it may be plagued with mechanical difficulties and last only five years. Machine B's price is \$100 more, but it may do a superior job, last fifteen years and have no mechanical difficulties. Machine B is clearly the better value, even though its purchase price is higher.

This issue of “price” is where economic theory becomes more complex. Most economic studies are unable to distinguish between these two concepts of price. “The price tag is still easy to read, but an understanding of price requires education.”¹⁰⁾

8) Baldwin, R., Cave, M. and Lodge, M. (2012) *“Understanding Regulation: Theory, Strategy and Practice.”* 2nd Edition, 2012.

9) Shewart, W.A. (1980). *“Economic control of Quality of Manufactured Product.”* American Society for Quality Control.

10) Deming, W.E.(1982), op. cit.

b. Giving consumers greater choice.

A common claim once competition has been increased is, “Now we have choice.” Having more than one supplier does allow consumers to compare and choose different prices and service qualities. However, these consumers rarely consider whether quality has declined or whether prices have risen as the result of increasing competition.

“An example is the fire and natural damage insurance industry in Switzerland. Switzerland has a dual system of property insurance for fire and natural damage. Nineteen of the twenty-six cantons have state owned cantonal insurance monopolies, from which property owners have to buy this type of insurance. In the remaining seven cantons there are no public suppliers and insurance cover can be obtained only from private providers.”¹¹⁾ The study found the Swiss cantonal insurance monopolies provided superior service and price compared to the private insurers.

Annex C shows the different cost structures and premium prices between the monopoly and private insurers in Switzerland. The monopoly insurers were found to be more than forty two percent cheaper than the private insurers.

c. Encouraging innovation.

It is commonly believed that competition promotes innovation. Whilst competition may force some organizations to search for

11) von Ungern-Sternberg, T. (2004). *Efficient Monopolies - The Limits of Competition in the European Property Insurance Market*. Oxford University Press.

innovative ideas, it is the quality of a company's management, which is the primary factor in determining if an organization will pursue innovation. Google is a quasi-monopoly and is continually innovating. The Swedish food packaging and processing giant Tetrapak is a quasi-monopoly for certain types of food packaging. It was founded in 1951 and has continually sought to innovate since its inception. "Its aseptic packaging technology has been called the most important food packaging innovation of the 20th Century by the Institute of Food Technologists and the Royal Swedish Academy of Engineering Sciences called the Tetrapak packaging system one of Sweden's most successful inventions of all time."¹²¹³) Its long life food and drink packaging has benefitted the world and especially countries where refrigeration is not available. Tetrapak management views innovation as one of the mainstays of its survival and growth.

Innovation is often the result of investment in research and development. Because the well-managed monopoly supplier will generally have a reasonable profit margin, they often have the greatest potential of innovating from research and development. "A monopoly has the best chance to be of maximum service to the world, and has a heavy obligation to do so. Maximum service requires, of course, enlightened management."¹⁴)

12) Ingram, F.C. (retrieved 2011). *"The Gale Directory of Company Histories"*.

13) Tetrapak. (retrieved 28 November, 2011). "Royal Swedish Academy of Engineering Sciences".

14) Deming, W.E.(1994), *op. cit.*

The disadvantages of competition

a. Good suppliers can be driven out of business.

“The policy of forever trying to drive down the price of anything purchased, with no regard to quality and service, can drive good vendors and good service out of business.”¹⁵⁾ Customers may be tempted to buy from the supplier with the lowest purchase price. If enough customers do this, it may drive the quality supplier out of business. The customer may not realize that what they have purchased is of poor quality until too late.

b. The quality of product and service can decline.

In January 2010, flooding in Queensland, Australia caused death and widespread property damage. Some people who had homes destroyed or damaged; found they were not covered for this type of flooding by their property insurance policy. This occurred because the definition of flooding differed significantly between insurers. This situation would not have arisen under the Swiss Cantonal insurance monopolies that exist in Switzerland. The Swiss monopoly insurers described earlier would have provided coverage for these losses.

c. Insufficient profit to allow for investment in research and development, and new technology.

Many companies have made important contributions to society by investing wisely in research, development and technology. In many cases, these advances were possible because the organization made a

15) Deming, W.E.(1982), *op. cit.*

reasonable profit. Competition can force a supplier to accept slim profits. This can result in a supplier having little or no money to spend on research and development, new technology and equipment. The result - society loses out.

d. Increased wasteful bureaucracy associated with introducing and enforcing competition.

Introducing competition to an industry that was once a monopoly can involve complex rules covering the sharing of infrastructure owned by the monopoly. An example is the 165 page Australian Competition and Consumer (ACCC) document - "A code of access to telecommunications transmission towers, sites of towers and underground towers." This is an aspect of competition policy that the ACCC does administer. People must be employed to write, monitor, enforce and administer these rules. The result - taxpayer funded waste.

e. Lack of standardization.

Standards have played a crucial role in the development of today's society. Examples include standardized sizes for most batteries, shipping containers, paper sizes, credit and bank withdrawal cards. Without standard battery sizes, customers might need to search tirelessly for a battery which fits their camera or flashlight. Without standard dimensions of shipping freight containers, international trade would be slower and more expensive.

"Microsoft was criticized by some for being a monopoly..... however, many people forget the great benefits Microsoft has given to

society. Microsoft was able to create and enforce universal data interaction standards for personal computers. They did this by creating a series of operating systems (DOS, then Windows) and defining the kind of machine that could run their operation systems. They were successful at this because, unlike their competitors, they set about creating non-exclusive standards that allowed anyone to get into the computer hardware business, and fill every market niche. Today almost every computer user in the world is able to use Microsoft programs to communicate. Microsoft Word, Excel and Powerpoint are among the most used software in the world. Microsoft became a monopoly because they created the most universally useful standard for desktop computers. When Microsoft was called a monopoly by the Antitrust Commission, the government did not recognize the problems associated with the break up of the corporation. If Microsoft were broken up, who would create and enforce the standards that make personal computers so useful? The federal government could create a situation where there are twenty little exclusive standards; each pushed by twenty competing corporations.”¹⁶⁾

f. Waste because of competition.

Competition can cause duplication. Industries that require large investments in expensive infrastructure are potential examples. Cesar Carbonari writes:

“A significant example of potential wasteful duplication can be found in the provision of cable television service. A court case of great interest

16) Carbonari, C. (2009). *“Subadditivity, cooperation and long-term results – W. Edwards Deming’s Thinking on Monopolies”*. Fordham University, New York, NY

in this regard was Omega Satellite Products Co v City of Indianapolis. In that trial, Omega Satellite products accused the city of Indianapolis of violating antitrust law by discouraging competition in the local cable market. However, the case judge said that, “the cost of the cable grid appears to be the biggest cost of a cable television system and to be largely invariant to the number of subscribers the system has.”

In addition she said that, “the average cost of cable television would be minimized by having a single company in any geographical area”. This meant that having a cable competitor would lead to a wasteful duplication and television subscribers would have to pay higher prices.”¹⁷⁾

Another potential area is duplication of marketing costs. In some industries companies spend large amounts of money on marketing to promote their product. A monopoly supplier can often keep marketing costs low, as they have no one to compete against. The value of monopolies and the waste caused by competition was well understood by an American, the late W. Edwards Deming.

Dr Deming's views

Deming was an eminent scholar and teacher in American academia for more than half a century. He published hundreds of original papers, articles and books covering a wide range of interrelated subjects - from statistical variance, to systems and systems thinking, to human psychology. He was a trusted consultant to influential business leaders, powerful corporations and governments around the world. This included

¹⁷⁾ Ibid.

inspiring and guiding the spectacular rise of Japanese industry after World War II, and the resurgence of the American automobile industry in the late 1980s.

Dr Deming was highly critical of governments that continually increased competition. “Economists teach the world that competition in the marketplace ensures that everyone gets the best deal. This may have been so in days gone by, when the baker had his customers, and the tailor his, the cheese-maker his and so forth. In those days it was fairly easy to make an intelligent purchase. It is different today. The Price tag is still easy to read but an understanding of quality requires education.”¹⁸⁾

Deming believed that increasing competition would ultimately result in harm to industry, consumers and society. Instead, he believed in managing organizations and industries as systems, and that cooperation between competitors, government, competition authorities, the public sector and other relevant organizations was essential if optimization was to be achieved. “If economists understood the theory of a system and the role of cooperation in optimization, they would no longer teach and preach salvation through competition. They would, instead, lead us into the best plan for a system, where everybody would come out ahead.”¹⁹⁾

What did Deming mean by ‘a system’?

Deming described a system as “a group of interdependent components that work together to try to accomplish the aim of the system.”²⁰⁾

18) Deming, W.E.(1982), *op. cit.*

19) Deming, W.E(1994), *op. cit.*

“Management of a system therefore requires knowledge of the interrelationships between all the components within the system. And of the people that work in it.”²¹⁾

“A system must be managed. It will not manage itself. Left to themselves in the Western World, components become selfish, competitive, independent profit centers and thus destroy the system. The secret is cooperation between components toward the aim,” “We cannot afford the destructive effect of competition.”²²⁾ It is management’s job to direct the efforts of all components toward the aim of the system.

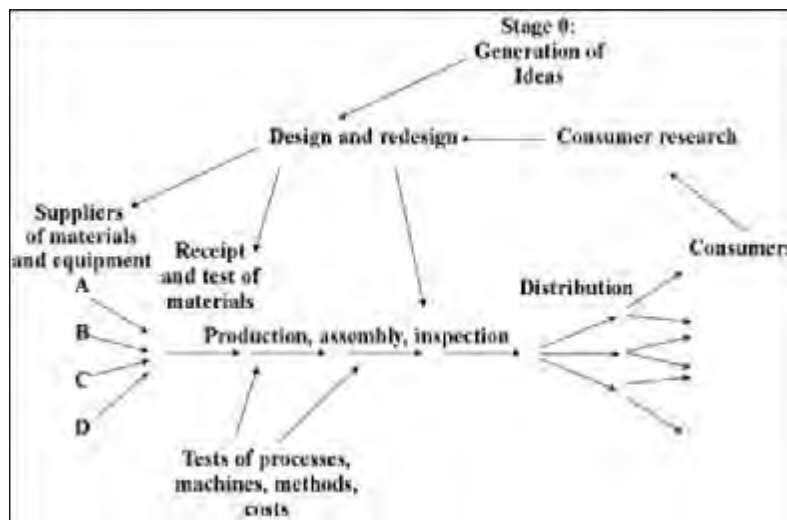


Figure 3 above shows the system diagram that Dr Deming used to illustrate this approach.

20) Ibid.

21) Orsini, J.N. and Deming, W.E. (2012). *The Essential Deming: Leadership Principles from the Father of Quality*. McGraw Hill.

22) Deming, W.E(1994), *op. cit.*

The Solution - Optimization, using a managed, systematic approach.

For consumers, industry and society to gain maximum benefit, it is essential that some industries be managed as a system for optimization. To achieve this, Deming explained that “efforts by competitors, acting jointly or together aimed at expanding the market and to meet needs not yet served, contributes to optimization for all of them. When the focus of competitors is to provide better service to the customer (e.g. lower costs, protection of the environment) everyone comes out ahead.

Typically, the management of a company spend a lot of time worrying about share of market. How big is our piece of the apple pie? How can we enlarge it at the expense of the competition?” It would be better if all the competitors would use this time and energy to expand the market. They would all gain.

Anything less than direction of best efforts of everyone towards achievement of the aim or aims of the whole organization is a directed effort towards failure to achieve best overall results. Everybody loses, even the people in a successful individual profit centre. Management’s job is thus clear - to achieve best results for everybody - everybody win. Time will bring changes that must be managed - must be predicted so far as possible. Growth in size and complexity of a system and changes with time of external forces (competition, new product, new requirements) require overall management of efforts of components. An additional responsibility of management is to be ready to change the boundary of the system to better serve the aim. Changes may require redefinition of the systems components.”²³⁾ An example of

an industry that is managed as a system for optimization is New Zealand's Eco-tourism industry in the North of New Zealand's, South Island. This industry is examined in detail in Annex D.

Unfortunately, as the study outlined below shows, optimization is not currently a central principle in the competition policy of the governments studied in this paper.

The 2011 research study conducted by Murray B. Stanley.

In 2011, letters were sent to the federal governments or competition authorities of Australia, New Zealand, Canada, the United States of America and the United Kingdom of Great Britain and Northern Ireland. The letters sought to determine whether any of these countries possessed a methodology to determine the optimal level of competition in industries that existed in their countries.

Responses were received from three of these countries, Canada, the United States of America and Australia. Of the three responses received, none mentioned a methodology to determine the optimal level of competition.

The response from the United States of America's, Department of Justice, Antitrust division was similar to the responses received from the other two respondents. The most relevant section of that letter is provided below.

23) Ibid.

"The Federal Antitrust laws do not seek a specific 'level of competition' in particular industries. Rather, they prohibit generally a variety of practices that restrain trade, such as price fixing conspiracies and corporate mergers likely to reduce the competitive vigor of particular markets, and predatory acts designed to achieve or maintain monopoly power. In addition, they apply to virtually all industries and to every level of business including manufacturing, transportation, distribution and marketing."

Although no responses were received from the competition authorities of New Zealand and Great Britain and Northern Ireland; an examination of their websites indicated a similar approach to the countries that responded.

No evidence was found that any of these countries viewed 'managing industries for optimization' as a central principle or goal of their federal governments. The table at annex E provides a summary of the study.

The approaches taken by these governments are in direct contrast to the approach that is proposed in this paper. This paper's approach is further explained below.

The Seven Pillars explained

Under the new competition model (figure 1), price is just one of several factors that need to be considered. As the model implies, managing the organization, industry or industries as a system is the most important factor.

Other critical factors include the quality of the product or service being sold. Externalities, like environmental impact. Cooperation between competitors, government and other agencies is crucial and is examined later in this paper. Social factors can also be considered under this approach. An example of an industry where social factors have been considered when determining the level of competition is the liquor industry in Ontario, Canada.

In this Canadian Province, most alcohol is sold by the Liquor Control Board of Ontario (LCBO). It is a government owned, quasi-monopoly that sells beer, wine, spirits and other alcohol to the public. LCBO stores are generally the only stores allowed to sell distilled spirits in Ontario. The LCBO is an example of a social consideration being taken into account when determining industry competition levels. This is because the LCBO places an enormous emphasis on social factors like preventing the sale of alcohol to minors, and contributing to many worthy, charitable causes. It also recently returned over 1.2 billion dollars in revenue to the Ontario provincial government.

Another critical factor that is closely related to industry competition is ownership. When governments privatize (sell) an industry, an increase in competition often eventuates. Whether a monopoly should stay in government hands or be privatized is an important issue but is not examined in this paper. A good reference on the subject is "Privatization: Sell off or Sell out," by Bob and Betty Con Walker.

Emeritus Professor Kolsen's views

Emeritus Professor Ted Kolsen was the head of Australia's University of Queensland's Economics department. Kolsen also understood the importance of cooperation between government, regulators and industry. He wrote multiple papers on competition policy, industry regulation and trade practices.

Kolsen understood that each industry needed to be carefully studied to determine how that industry should be managed. In 1995 Kolsen also predicted that some of the competition policy reforms that were being proposed in Australia would ultimately prove unsuccessful.

"The conclusion is that an industry by industry approach can not be avoided. The application of homogeneous 'competition principles' will inhibit such an approach, and will sometimes be applied in circumstances where less competition would produce higher levels of economic efficiency." "The various agreements and the Australian Competition and Consumer Commission legislation are almost totally devoid of appreciation of some of the fundamental problems in the application of simple principles to complex industry situations. The attempt to apply what has been called the 'one shoe fits all' approach is likely to conflict with economic efficiency in some cases, with social policies in others."²⁴⁾

Kolsen also understood that in some industries, competition may need to be decreased, instead of increased. "There will be some industry

24) Kolsen, T. (1996). *"Microeconomic Reform and National Competition Policy: Misconceptions and Problems"*.

conditions in which there is economic inefficiency because there is too much competition. Competition policy directed at economic efficiency thus must be able to provide mechanisms for reducing competition as well as for increasing it, depending on the nature of the constraints in particular industry sectors.”²⁵⁾

When Kolsen was being interviewed on proposed changes to the Sugar Industry in Australia, he said that the proposals to deregulate the industry were based on competition models that seem to assume that cane growers delivering to the sugar mill for processing, “could auction off the cane to the highest bid by the millers. This is nonsense.” As there is a technical requirement to harvest over a short period when the cane has its best sugar content, and for the mill to process the cane quickly before it deteriorates, this requires “cooperation, not competition, under an umbrella of regulation between millers and growers.”²⁶⁾

Cooperation is the secret

For optimization to occur it is critical that components of the system (including competitors) cooperate towards the aim of the system. An excellent example of cooperation between competitors occurred in the 1980's.

“When home video recorders first became available, two incompatible systems were introduced by two large consortiums. One was the Beta system led by Sony and the other was the VHS system led by

25) Ibid.

26) Kolsen, T. (8 March, 2003) *“AGRICULTURE: Sugar industry reports: 'social science fiction'”*.

Panasonic's corporate parent Matsushita. Both standards were directed towards the same consumers for the same purpose. Neither had any significant advantage over the other. Eventually one won out, but only after great loss to consumers who had tapes they couldn't play on the new machines and machines that couldn't play the newer tapes. The market developed more slowly than it could have. Movie companies lost, having to produce two versions of each movie. This kept their costs up and prices higher than would have been the case if only one standard existed. This resulted in great loss to consumers and producers alike.

The lesson wasn't lost on the manufacturers. Recently Matsushita and Sony joined N.V. Phillips, the large Dutch electronics firm, to establish a standard format for the new, sound, data, graphics, and video information technology called compact disk interactive."²⁷⁾

Conversely, a lack of standardization can be damaging to society. An example of a cooperation opportunity lost may be mobile phone chargers. If several major mobile phone companies had cooperated in setting a standard, we may have one mobile phone charger that suits all phone brands. Many years after the introduction of mobile phones, the situation is now trying to be recovered. After pressure from the European Commission, mobile phone manufacturers have agreed to develop a standard phone charger to be sold in the 27 European Union member states.²⁸⁾

More recently, four Japanese companies and several levels of Japanese

27) Aguayo, R., *op. cit.*

28) Forbes, R. (2011). Internet article - "*Commission issues guidance on standardised mobile phone charger.*" Located at:
<http://www.internationallawoffice.com/newsletters/detail.aspx?g=bf5cfe0c-b194-472a-9895-45d42bacbf7>

government have demonstrated an excellent example of cooperation between private industry and government.

“In July, 2013, Toyota Motor Corporation, Nissan Motor Co., Ltd., Honda Motor Co., Ltd., and Mitsubishi Motors Corporation jointly announced their agreement to work together to promote the installation of chargers for electric-powered vehicles and build a charging network service that offers more convenience to drivers in Japan.

The move was in recognition of the critical need to swiftly develop charging infrastructure facilities to promote the use of electric-powered vehicles. Assisted by subsidies provided by the Japanese government, the four automakers will bear part of the cost to install the charging facilities. They will also work together to build a convenient and accessible charging network in collaboration with companies that are already providing charging services in which each of the four automakers already have a financial stake.”²⁹⁾

This sort of cooperation is most likely to occur when governments create the conditions and the environment that are conducive for it.

Government policies must encourage cooperation

For cooperation between competitors, government and other relevant organizations to flourish, it is critical that government policies and legislation are specifically designed to encourage it. The problem is that the competition legislation that exists in many Western countries is not

29) Honda Newsletter, News Release, 29 July, 2013. *“Toyota, Nissan, Honda and Mitsubishi Agree to Joint Development of Charging Infrastructure for PHVs, PHEVs and EVs in Japan.”* Honda Motor Corporation.

geared in this way. The overwhelming emphasis of this legislation is on promoting competition. This does not provide a conducive environment for cooperation.

Researchers Frans van warden and Steven Casper understood this. “If inter-firm cooperation is so conducive to innovation, should one not develop policies that stimulate it and refrain from measures that discourage it? An example may be competition policy. Recently, the Netherlands has changed its competition policy from an abuse principle to a prohibition principle. One may wonder if sufficient thought has been given to the possible effect on innovative capacity.”³⁰⁾

“Economists often have a Pavlovian reaction as regards competition. It is ‘good’, provides incentives, keeps business on its toes, stimulates entrepreneurship and growth, and provides an incentive for innovation. Under certain conditions that may be true. However, it may also backfire, and have more or less unintended effects.”³¹⁾

In an environment where competition is the dominating principle, “inter-firm cooperation becomes more suspect and is more liable to cause legal problems. If nothing else, that will make entrepreneurs more careful about entering into longer-term cooperation with competitors, suppliers or customers.”³²⁾

Therefore, governments must ensure that competition policy and other

30) Van warden, F and Casper, S. (2005). *“Innovation and Institutions: A Multidisciplinary Review of the Study of Innovation Systems (New Horizons in the Economics of Innovation)”*. Edward Elgar Publishing.

31) Ibid.

32) Ibid.

relevant policies like education, infrastructure, science and technology encourage economic cooperation instead of inhibiting it.

Three potential levels of competition

Under the new competition policy approach discussed in this paper, there are therefore three possible competition level scenarios. Each industry (or component of an industry) would be placed into one of the three scenarios described below. All three scenarios can be managed under one competition policy.

- Open unrestricted competition. Sometimes referred to as a 'free market approach'.
- A managed and restricted amount of competition. This is sometimes referred to as regulation.
- A monopoly supplier.

Flexibility is required to determine the optimal approach and competition level for each industry. The MROCK model located in Annex F gives government and regulatory agencies a method to determine the optimal approach. This differs entirely from the 'one shoe fits all' approach presently adopted by Australia and many other Western governments.

New roles for Political leaders and competition authorities

Under the new approach, political leaders and competition authorities would have vastly different roles. Government and competition authorities would actively seek out opportunities to help organizations expand their

markets and would encourage cooperation between competitors, government departments and other relevant agencies. Government and industry would work together. Another role for competition authorities would be education. “Education, to achieve maximum benefit from monopolies and cartels. This would be far better than to spend time in search of imaginary violators as victims.”³³⁾

On occasions, some organizations may practice short term, destructive, monopolistic behavior. “Suppose the aim of a company were short-term profit. Set the price as high as the traffic will bear. Make a big profit in a hurry and get out. A useful function of the Antitrust Division would then be protection of society.”³⁴⁾ Another important role for competition authorities would be to work with government and industry to help determine the best management approach and the optimum level of competition for each industry or system. Part of this role would include improving the list of issues in Annex F.

II. Findings

- Some governments have introduced competition to industries without carefully studying those industries and without fully understanding the implications of their decisions. As a result, prices have risen and quality has declined in some of these industries.

33) Deming, W.E.(1994), *op. cit.*,

34) Ibid.

- Some monopolies have been broken up on the erroneous belief that a monopoly supplier cannot produce better results for consumers than a competitive industry.
- The study found no evidence that a consistent and systematic method for determining the optimal level of industry competition was being used by any Western government studied.

III. Conclusions

Governments and competition authorities need to take a far more active role in managing competition policy. They must be aware of the advantages and disadvantages of competition in every industry and, where necessary, manage those industries for optimization. Leaving all industries to free market forces can result in higher prices, lower quality and a decline in innovation.

The focus of competition policy must switch from 'increasing competition' to optimization. By providing the leadership recommended in this paper, governments and competition authorities would help industries expand their markets, and improve quality and price by minimizing waste and duplication. Industries, consumers and society will benefit from increased cooperation, innovation and research.

Annex A Letter from the Australian Federal Government

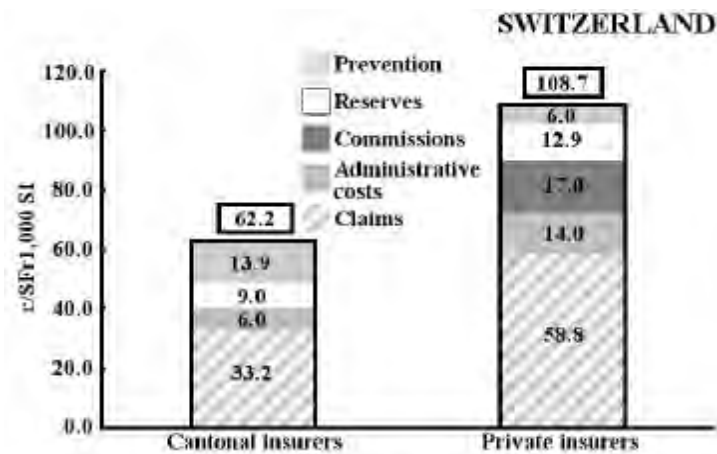


Annex B Chart of Brisbane(Australia) electricity prices



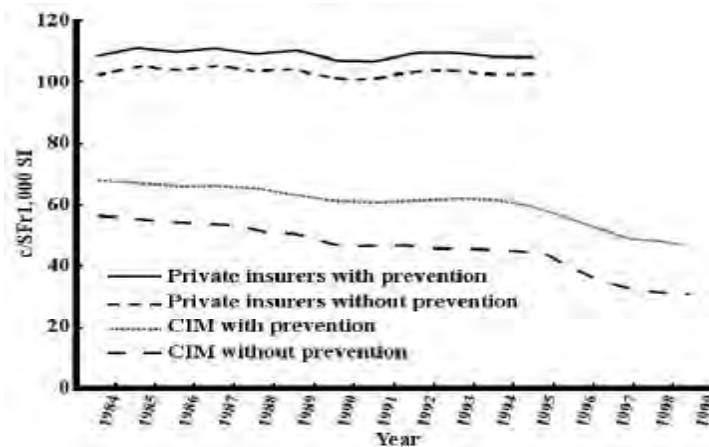
*Source of data - Australian Bureau of Statistics

Annex C Swiss Property Insurers



Comparison of cantonal and private premiums (fire and elemental damage), 1986-1995.

Source: VKF (various years), *Finanzstatistik*.



Evolution of premiums in the housing insurance market, 1984-1989.

Sources: For the CIM: VKF (various years), *Finanzstatistik*. For the private insurers: Bundesamt für Privatversicherungswesen (various years).

Annex D Eco-tourism Industry, New Zealand's South Island

An example of an industry that is neither a monopoly nor a free market industry is the Eco-tourism industry in the Abel Tasman and Kahurangi National Parks of New Zealand's South Island. This industry is managed with sustainability, consumers, residents, the environment and optimization in mind.

Background

Around 2001, tourism operators in this industry believed that the number of privately operated tours operating within the national parks had reached saturation point. They believed that the region's striking scenic features, unspoiled qualities and visitor experiences were at risk of being damaged if the number of visitors and tours were not restricted and managed appropriately.

Development of management plan

In cooperation with the relevant stakeholders, the Department of Conservation developed a management plan to ensure that too many visitors did not harm the industry and visitor experience. This management plan had the force of law and was developed under New Zealand's Conservation Act (1987).

Tourism operator restrictions included in the management plan were:

- A maximum of 50 guided walking groups (maximum group of 16 including 2 guides) per day.

- A maximum of 56 guided kayak groups (maximum group of 8 clients, 2 guides) per day.

The stakeholders believed that if visitor numbers exceeded these figures the quality of the visitor experience would suffer and the environment would be harmed.

The coordinating organization was New Zealand's Department of Conservation. The industry is represented in the diagram below.



Diagram by Jesse Smith

The number of tourism operators (and therefore competition) in this industry were restricted by a licensing arrangement. In this particular market, competition is limited but new entrants can still enter the market by buying an existing operator license.

Conclusion

For the purposes of this paper, the most important point to take from this example is that competition was primarily restricted on grounds of quality of experience for all visitors (commercial and freedom). Other factors were also important. e.g. environmental factors and access to facilities (which in turn were governed by resource consents).

Annex E Table comparing responses from governments or competition authorities.

	Date letter sent	Date response received	Response mentions an optimization methodology.
Country			
Australian Government	May 2011	Response received late 2011. Letter undated.	No
United States of America, Department of Justice -Antitrust Division	November 2011	05 January 2012.	No
Competition Bureau of Canada	November 2011	07 December 2011.	No
New Zealand Competition Commission	November 2011	No response received as at 18 November, 2013.	* Not applicable – no response received.
United Kingdom of Great Britain and Northern Ireland Competition Commission	November 2011	No response received as at 18 November, 2013.	* Not applicable – no response received.

Annex F Issues to consider when determining the level of competition for an industry (MROCK model)

1. *To what degree would the introduction of competition result in the duplication of infrastructure, equipment or services, such that the total cost of the industry is likely to increase? Will these increased costs be passed on to the customer in the form of increased prices?*
2. *To what degree would cooperation between organizations be a better alternative to increasing competition?*
3. *Could increasing competition mean that essential or desirable services are cut to less profitable areas or routes? Therefore depriving the public of an essential or worthwhile service.*
4. *How many competitors could operate profitably within this industry? Consideration should be given to whether that industry has the potential to expand.*
5. *To what degree would increasing competition in an industry potentially result in wasteful and costly bureaucracy that did not exist previously?*
6. *To what degree would the quality of the product or service be diminished if competition is introduced or increased?*
7. *Is the industry one where massive infrastructure costs are involved?
A monopoly may be the only type of organization capable of making the massive infrastructure expenditure required.*
8. *Is the industry one where research and development benefits the country, region or society? To what degree would the introduction of competition cause a reduction in profit margins that affect the organization's capacity to conduct research and development? What impact could a reduction in research and development have on*

customers, the country, region or society?

- 9. To what degree is the industry an essential service where management with greedy or short-term profit motives may reduce or eliminate spending on things like maintenance and investment on infrastructure?*
- 10. Is the industry one where a monopoly determines standards that benefit the country or society? If so, will these standards continue to exist if competition is introduced or increased?*
- 11. Does the monopoly currently play a role in "Prevention"? e.g. The Swiss property insurance industry described in this paper. What will be the impact of increasing competition in such an industry?*
- 12. What impact would an increase in competition have on health and safety and/or the environment?*
- 13. What role (if any) do government agencies need to play in management of the industry?*
- 14. Would the introduction of more competition mean that an entire network or system could not be shut down and replaced with a superior network or system? Therefore resulting in society having to operate and maintain more than one system.*
- 15. Are there extraordinary security issues, where an extremely tight control needs to be kept on an industry? e.g. The currency printing industry.*
- 16. To what degree would the introduction of competition destroy or damage a monopoly that is capable of producing superior service and/or a cheaper price?*
- 17. Would it be beneficial for consumers or society, for an industry to have a restricted level of competition for an initial period, e.g. twenty years, and then be opened up to more competition after*

that initial period?

18. *If governments introduce or increase competition in an industry, which individuals or groups would be potential beneficiaries? e.g. Current donors to political parties.*
19. *Under what circumstances should price fixing be legalised and encouraged? e.g. to ensure a certain level of quality.*
20. *If a decision is made to increase competition and prices increase or quality declines as a result, can this decision be reversed? How much will this reversal cost?*
21. *Are there other factors where the introduction or an increase in competition may adversely affect customers or society? Is so, what are they?*

The M-ROCK model/procedure above remains the copyright of Murray B. Stanley.

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THE COMPETITION MYTH

Why Competitive Tendering Fails to Deliver

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Abstract.

Competitive tendering (bidding) is a widely used procurement method. The idea behind competitive tendering is that it forces suppliers to compete and consequently the purchaser will gain better “value for money”. This paper challenges that belief and shows why competitive tendering is rarely an efficient and effective procurement method.

Introduction.

This paper will explain why the result of competitive tendering is often inferior, poor quality product or service. It will:

1. List the perceived advantages of competitive tendering.
2. Outline the disadvantages of competitive tendering.
3. Discuss who is generally blamed when competitive tendering produces bad results.
4. Propose a better procurement model.
5. Discuss potential barriers to implementation of the improved procurement model.

Dr Deming wrote important sections on customer supplier relationships. This paper aims to build on that work.

Most relevant is Dr Deming’s comment in *The New Economics* that states “The idea of several suppliers for any one item, competing with each other for lower prices (as advocated by some authors), makes good talk, but as a practical matter it is only talk, even under long term contracts. It destroys any possibility of a good relationship between customer and supplier. The losses would be one of those unknowable figures”.

Competitive tendering (what is it?)

Competitive tendering involves a purchasing organization advertising business and requesting tenders to supply that business. In some countries the tendering process is called “bidding”. Competitive tendering can be broken into two main types:

1. Open competitive tendering is where the invitation to tender is publicly available for all interested suppliers to respond. This method is most commonly used in government organizations.
2. Closed competitive tendering is where the invitation to tender is issued to a predetermined, or restricted number of suppliers.

In some countries the use of competitive tendering is mandatory for government agencies. For example, most Australian Government agencies are required to go to tender if they intend to make purchases over eighty thousand Australian dollars⁽¹⁾. Some exceptions apply. Tenders are generally advertised via an on-line website called Aus-tender.

The advantages of competitive tendering.

Competitive tendering is often considered to have the following benefits:

1. It promotes competition between suppliers, resulting in best “value for money” for purchasers and users. This point will be extensively challenged in this paper.
2. It “offers a kind of transparency that helps mitigate favoritism and corruption”⁽²⁾.
3. In the case of open tendering, it gives all suppliers the opportunity to win the business that is advertised.

The author acknowledges that points 2 and 3 above are notable benefits of competitive tendering. These benefits need to be considered and weighed against the factors raised later in this paper.

The disadvantages of Competitive Tendering.

Competitive tendering has many disadvantages. Because there are different types of competitive tendering, not all the disadvantages outlined below will apply in every situation. Factors such as whether open or closed competitive tendering is used; or whether competitive tendering is being used by a private or government organization will determine if these disadvantages apply. The disadvantages include:

1. Leading suppliers may not tender.

Most Australian government procurement guidelines only allow suppliers who actually tender to be considered for a procurement decision. If the leading supplier or suppliers do not tender, the purchaser can only consider bids from suppliers who do tender. If leading suppliers are not considered, the purchaser may end up buying inferior product or service.

There are several reasons leading suppliers may not submit a bid. These include:

1. The expense of the tendering process. Some complex tenders can involve huge costs that are not reimbursed to the bidder.
2. Suppliers may not believe that the tendering process is fair.
3. Suppliers may already be heavily committed to other customers and may not need the business that is being advertised by the purchaser. The supplier may be so popular that he has a waiting list.

2. Barriers to communication between supplier and customers.

When making significant purchases, frank and open communication between potential supplier and customer is crucial. Competitive tendering is not conducive to open communication.

“Practitioners have recognized that competitive tendering stifles valuable coordination between the procurer and potential supplier before the plans and specifications are finalized. To see this, note that the primary information that the procurer receives from suppliers in a competitive tender is their bid. A supplier has no incentive to offer the procurer advice on how to improve the plans or avoid certain pitfalls. In fact, the supplier would have the incentive to keep any findings of this kind to himself as they offer him a competitive advantage over his rivals in a competitive tendering process”(2).

However, when more effective procurement methods are used “the procurer and supplier typically spend a good deal of time discussing the project before the work begins. During such negotiations the procurer can elicit the supplier’s views about where the designs and specifications can be improved”.(2) Potential problems and pitfalls with the proposed work can also be discussed.

3. The cost-plus phenomena.

Competitive tendering often results in strictly worded contracts between supplier and procurer. Deviations to contractual terms can be extremely expensive. This can create a situation that is sometimes referred to as “cost-plus”.

Dr Deming describes the situation in *Out of the Crisis* – “There is a bear-trap in the purchase of goods and services on the basis of price tag that people don’t talk about.

To run the game of cost plus in industry a supplier offers a bid so low that he is almost sure to get the business. He gets it. The customer discovers that an engineering change is vital. The supplier is extremely obliging, but discovers that this change will double the cost of the items.

It is too late for the customer to try and make other arrangements. Production is under way and must be continued without interruption. The vendor comes out ahead”.

4. Use of cheaper, poor quality materials and/or labor.

A supplier forced to play the competitive tendering game may come under pressure to keep costs down to ensure he gets a satisfactory profit margin. One way a supplier can lower costs is by using cheaper labor and/or materials. If the cheaper labor and materials are poor quality, the procurer will often end up with inferior, poor quality product or service.

5. Safety shortcuts.

Another area where suppliers may be tempted to lower costs is safety standards.

The British film “The Navigators” provides an example of a safety short cut taken as a result of competitive pressures. To keep costs down the tendering group reduces costs by cutting back on manning. In this case, the manning reduced is a safety critical role. The result is the death of a co-worker.

6. Competitive tendering can be extremely slow.

When government agencies use competitive tendering it can take several years to choose a successful bidder. The result is the customer can wait incredibly long periods for product or service that may be required quickly. By comparison, the use of direct sourcing procurement can take a fraction of that time.

7. A Supplier who wins the tender, but is unable to meet the contractual requirements.

A problem that compounds the problem of competitive tendering’s lengthy time frame, is when a selected supplier is unable to meet the requirement that he has contracted for. To the procurer’s frustration, the lengthy competitive tendering process may have to begin again.

8. The 300% mess around tax.

Sometimes private sector companies will go to tender simply to determine if the price they are paying is a fair market price. Companies with a reputation for doing this are often the recipients of what a colleague in the mining industry referred to as a “300% mess around tax”. Because the bidder knows the “purchaser” is not genuinely interested in making a purchase, he submits a heavily inflated bid with a 300% loading added. In this type of situation, the supplier’s time is being wasted.

9. Insufficient profit margin to allow for investment in research and development, new technology or equipment.

Many companies have made important contributions to society by investing wisely in research, development and technology. In many cases, these advances were possible because the organization made a healthy profit.

As previously mentioned, competitive tendering can force a supplier to accept a very slim profit margin. These low margins can result in a supplier having little or no money to spend on research and development, new technology and equipment. The result - society loses out.

Who gets the blame when competitive tendering produces bad results?

When the results of competitive tendering are bad for the purchaser, a scapegoat is often found. Someone will claim that the “Statement of requirements” were written poorly. The “Statement of Requirements” is the document that defines the product or service that is being put to tender. The claimant may argue that critical information was omitted or that the requirements were poorly worded.

This scapegoating generally shows a misunderstanding of several crucial points.

Dr Deming stated in *The New Economics* that “Any supplier worthy of consideration possesses specialised knowledge about his products – more than the customer can hope to have, even though the customer will be the user of the supplier’s product”. As it is the purchaser who writes the “Statement of requirements” (often without the input of potential suppliers); it shouldn’t be a surprise that these requirements are not

written as well as they could be. As previously mentioned, crucial communication between supplier and purchaser is already stifled or prevented as part of the competitive tendering process.

Furthermore, Dr Deming pointed out in *Out of the Crisis*, that from his experience “94 percent of the problems come from the system, rather than the worker”. Blaming the person who writes the “Statement of Requirements” is a case of blaming the worker, instead of working to improve the system.

A better procurement model.

The type of solution to competitive tendering will vary depending on several factors. These factors may include; the type of industry, the complexity of the product, the price of the purchase, whether the purchase is a one-off or a long-term supply relationship. The following key principles however, can apply to the majority of procurement decisions.

- Thorough research of the purchasing requirement and/or alternatives.
- Open communication with current or potential suppliers.
- Purchasing decisions based on a strong relationship of trust.
- Developing a long-term and healthy relationship with a reputable supplier or suppliers.
- Paying the supplier a fair profit margin.

A supply system that is held in high regard is the Toyota Production System.

Jeffrey Liker states in the *Toyota Way* that “Even when Toyota became a global powerhouse, it maintained the early principal of partnership. It views new suppliers cautiously and gives only small orders. They must prove their sincerity and commitment to Toyota’s high performance standards for quality, cost and delivery. If they demonstrate this for early orders, they will get increasingly larger orders. Toyota will teach them the Toyota way and adopt them into the family. Once inside, you are not booted out except for the most egregious behavior”. “Simply switching supplier sources because another supplier is a few percentage points cheaper (a common practice in the auto industry) would be unthinkable”.

Bringing about improvement in procurement methods will be different depending on the type of organization. In private sector organizations it may simply take a change in view from top management. In the Public sector it would mean changing Public Sector procurement policy. Before this could happen, the government of the day would have to approve those policy changes.

Potential barriers to implementation of the improved procurement model.

The biggest barrier to implementing improved procurement methods in government agencies is convincing the relevant decision makers that it is acceptable to move from a system which is “open to everybody to tender” to a system which is not.

In government organizations, procurement methods are influenced by politicians. For a politician, transparency is incredibly important. If a procurement process produces a poor result, a politician can say “the organization conducted a thorough and transparent procurement process. All suppliers that tendered were carefully considered.” Allowing every supplier the opportunity to tender for a contract could be compared to a government job being advertised and all members of the public having the opportunity to apply for the job.

Convincing politicians to adopt a system with less transparency and which does not allow all potential suppliers to tender will be challenging. However, this is what must occur if improved procurement methods are to be implemented. The potential beneficiaries include users, purchasers, suppliers and taxpayers.

Conclusion.

Competitive tendering rarely produces what is best for the customer. It is not efficient and is rarely effective. The exact amount of damage done by this procurement method is unknown and unknowable. To bring about improvement; organizations’ requirements for effectiveness and efficiency will need to outweigh their requirements for their procurement business to be open and available to all suppliers.

This paper recommends abolishing competitive tendering. Where possible, long term, mutually beneficial relationships should be developed with trusted and reputable suppliers. Selection of these suppliers should be based on thorough research. The selected suppliers should be paid a fair profit margin for the quality product or service they provide.

Footnotes

(1) *Commonwealth Procurement Guidelines Page 26, Paragraph 8.4 (2008). Commonwealth of Australia.*

(2) *Tadelis, S. and Bajari, P. (2006). Incentives and Award Procedures: Competitive tendering vs. Negotiations in Procurement.*

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