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Performance, profit and consumer sovereignty in the English deregulated bus market

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ABSTRACT

The pure free market will theoretically result in economic efficiency being achieved. At the heart of this proposition is the idea of consumer sovereignty, where producers that best meet the material wants of consumers will be the most successful. With some notable exceptions however, few transport markets work along free market principles, and hence by implication with little consumer sovereignty. Deregulated bus markets however, 'should' show evidence of the theorem. This paper therefore examines the English deregulated market to examine if this is indeed the case. An overall assessment of performance in terms of fare levels, technical efficiencies, profitability and user satisfaction is undertaken, and a correlation matrix estimated from which some overall patterns become clear. This is further developed through a more formal cluster analysis, out of which emerges a clear five cluster model. Clusters identify operators as classic oligopolists, efficient profiteers, mature market operators, the consumers' choice and the low fare operator. The overriding conclusion is that whilst there is some evidence of consumer sovereignty, the vast majority of local English bus markets contain producer centric operators that remain protected by significant barriers to entry. As a consequence, the market cannot regulate its own behaviour to produce economically efficient bus services.

1. Introduction

The Transport Act 1985 removed all economic regulatory controls relating to fare levels, frequencies and market entry from the staged British bus market outside of London. As such, the market was freed from what had been fairly strict regulations and left to operate far more along the lines of the free market. The Act also privatised the publicly owned National Bus Company and required local authority operators to be taken out of public administration and set up as arms length companies, with the general idea that these would be sold to the private sector. This subsequently occurred in the vast majority of cases over the next five to six years. Reasons for major reform are well known and well documented, but probably best summarised at the time by Banister (1985), who highlighted declining patronage, rising fares, massively increasing subsidy levels and rising costs. The reforms were designed to focus the bus industry far more on market principles, but rather than economic efficiency being achieved through direct competition, it was predicted that in the main it would come about as a result of (free market) contestability (Baumol, 1982). It would thus arise out of the threat of competition rather than actual competition itself (Beesley & Glaister, 1985).

A key component of the free market is that the 'consumer is king', in other words, consumer sovereignty will determine market needs and outcomes. Accordingly, after reform the bus services that would be provided would be more consistent with what the consumer wanted rather than what a local authority thought the consumer wanted, or in a worse case what it could afford to provide. Up until now it has not been possible to establish the extent to which consumer sovereignty has been achieved in any part of the British deregulated market. Most of the evidence that is available, reviewed later in this paper, would by implication suggest that it has not been present, but this has never been a formal consideration. Using data from the national bus passenger survey, this paper attempts to match overall consumer satisfaction and value for money figures against a number of operator related variables, specifically fare levels, profit margins and technical

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efficiency in order to identify producer centric and consumer centric operators. The study focuses exclusively on the English local bus market.

2. The concept and idea of consumer sovereignty

Often overlooked as a concept if not an idea, consumer sovereignty simply means that the consumer is king but, as Scitovsky (1962) notes, this should not be confused with individual sovereignty. 'King' in this sense is with regard to the market, as the consumer is only one facet of being an individual. Lerner (1972) highlights that the basic idea of consumer sovereignty is very simple, and that is to arrange that everyone has what they prefer as long as this does not involve a sacrifice for anyone else. He goes on to state therefore, that the full achievement of consumer sovereignty is often referred to as the 'ideal output'.

Gunning (2009) suggests that, as a concept, the theorem of consumer sovereignty was original devised by Ludwig von Mises. According to Gunning, von Mises took the Austrian theory of value and cost (the value in something is what the consumer places on it, not how much it cost to produce) and combined it with his own theorem of the harmony of rightly understood interests, to produce what Gunning terms the theorem of consumer sovereignty. The theorem states that entrepreneurs will always act in the interests of individuals in the consumer role. As a consequence, the consumer will determine which goods and services will be produced and in what quantities, and which entrepreneurs/firms will be most successful. This is an important facet of public transport reform (from state to private), as it considerably enhances consumer empowerment and should result in the production of services that more closely match individual consumer needs. All of this is achieved through market actions, i.e. where and on what consumers spend their incomes. In many ways, that is the 'idea' of consumer sovereignty, in that consumers get what they want, and firms that are best at providing that are the ones that prosper. The 'concept' however is the process that enables this to happen, and key in this is the very basic economic notion of consumers maximising their utility from limited resources. In *Human Action*, Von Mises (1949) highlighted that the providers of goods and services were forced to arrange their processing of the factors of production in such a manner that ensured that consumer demands were fulfilled in the best and cheapest possible way. This would therefore represent 'best' value for money. Those that failed to do so, would be supplanted by those that could. Von Mises further argued that such a process would occur throughout (what is now called) the whole supply chain, thus ensuring continued efficiency in production and distribution. This further underlines Lerner's (1972) notion of consumer sovereignty equating with an 'ideal output'.

Many have argued whether consumer sovereignty actually exists in the market place and whether it is such a key cornerstone of the workings of the free market. Scitovsky (1962) highlights that in the 'modern' era of mass production, the idea of consumer sovereignty may be considered to be significantly diminished (and even questionable as an 'ideal'), as firms can no longer cater for individual needs. Production therefore tends to focus on what marketers think consumers want, and this stifles innovation and risky products and results in production for the masses. Developing Scitovsky's argument further, globalisation has resulted in mass production on a global scale, hence market transactions are no longer confined to national boundaries but rather global markets. The net effect has been to further distance both culturally and geographically the producer from the consumer, and by implication reduce the impact the latter may have on the former. Other criticisms have come from behavioural economists, who argue that there may be consistent biases in consumers' behaviour, and as Nagarajan (2006) notes, particularly from the 'endowment effect' and the 'framing effect'. In simple terms, the first relates to consumer loyalty, where the consumer will remain loyal to a particular supplier irrespective of the price, the second suggests that purchase decisions will be based on the terms and the manner in which various choices are presented. Whilst the first is not inconsistent with the idea of consumer sovereignty (particularly with regard to overall utility), the second is, as it suggests there is no 'one size fits all' type approach. Finally, as the real 'power' of consumer sovereignty is primarily based on an assumption of perfect competition, Gonse (1990) lists the issues of externalities, consumer irrationality, variations in the distribution of income of consumers and imperfect markets as further criticism of what is a highly theoretical position.

Finally, the most notable, and controversial, critic of consumer sovereignty was the highly esteemed American economist J. K. Galbraith. In *The Affluent Society*, Galbraith (1958) argued that the economy had come to be dominated by a large number of firms, who were in a position to organise their research and development and marketing functions such that they could impose upon the consumer the goods and services they produced. Rather than 'consumer sovereignty' therefore, what this resulted in was something Gintis (1972) later termed Galbraith's theory of 'producer sovereignty'. Galbraith's views were not without counter critics, such as Zinkin (1967), who argued that new products or changes in style of service were simply a way of satisfying old wants in a new way, and thus could not be conceived as being artificially created by large corporations in order to sell their wares.

As can be seen from the above, the degree of debate over the existence or otherwise of consumer sovereignty is considerable and at a very high academic level. Many of the criticisms put forward, particularly given the topic under consideration, are clearly valid. To bring the discussion directly back to the topic however, the purpose of this research is to attempt to establish the extent to which producer rewards are linked to consumer satisfaction in the British bus market. This is undertaken by an examination for the existence or otherwise of consumer sovereignty, i.e. to establish the extent to which the reality of public transport reform matches the theoretical 'ideal output'. Finding evidence of Galbraith's producer sovereignty is not inconsistent with this purpose, as the focus of this research is on empirical rather than theoretical issues.

3. Literature review

The literature review focuses on a narrow body of research specifically examining very specific short and longer term outcomes from British bus deregulation, as well as briefly considering policy developments since the 1985 Transport Act. Two key sources in this area are Peter White's papers (White, 1995, 1997) which specifically assessed the impact of deregulation in what could be termed the short term. What White found was that while the cost per kilometre operated had fallen, patronage had also fallen and profitability only remained 'marginal'. Cowie (2002) looked at the issue of industry consolidation and charted industry structure over the post deregulation period. What he found was that company growth had been achieved almost exclusively through external rather than organic growth. In other words, growth had been realised by merger and acquisition rather than by developing demand directly. This had resulted in the dominance of the market by five (stock market listed) major operators. As a consequence, this had significantly reduced the level of actual and potential competition in the market. Preston and Almutairi (2013a) examined the longer term effects of British bus deregulation. Their research suggests that deregulation not only failed to halt the long term

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