

Government 2332

PEREG Lecture 2

The Classical Theory of Regulation

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Basic Question: Why Regulate?

1. The basic Q animating all of classical reg theory
2. Notice that question is not...
 - (a) How did we get regulation? (causes)
 - (b) Who wins and who loses under reg? (distribution of payoffs)
 - (c) How does reg actually work? (results)
3. Breyer's approach: need medium ground btw general answers to this Q and specific ones.

Breyer's Types of Regulation

- A. Classical Problems ["Market Defects"]:
 1. Monopoly Power
 2. Spillovers
 3. Information Asymmetry (Lemons)
 4. Excessive Competition
- B. Classical Solutions
 1. Cost-of-Service Ratemaking, or ROR-Reg
 2. Mandatory Caps upon the Externality
 3. Mandatory Labels, Screening
 4. Explicit Entry Barriers

I. Monopoly Power

Much more on this next Monday, but for now...

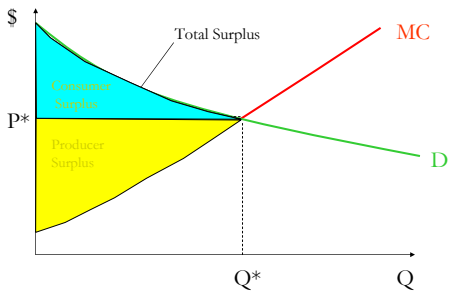
A. Basic issue: some industries may efficiently support only one firm (economies of scale).

B. Average Cost is \downarrow ing through interval of consumer demand.

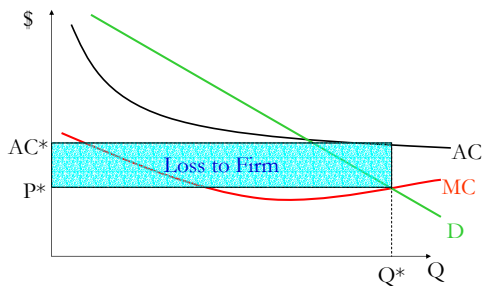


C. Basic problems: (1) monopoly pricing ($> MC$), (2) price discrimination, (3) possible inefficiency.

Review: Baseline Competitive Economy

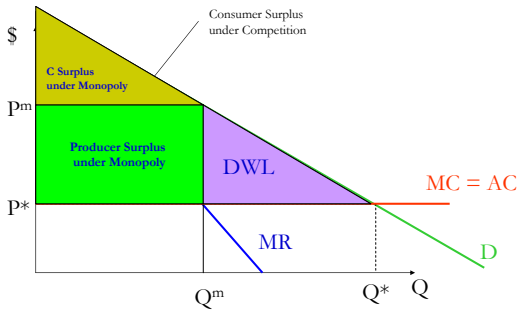


When Firm Loses \$ at MC Pricing



Review: Competition v. Monopoly

(Illustrative Case of Constant Marginal Cost)





I. Monopoly Power

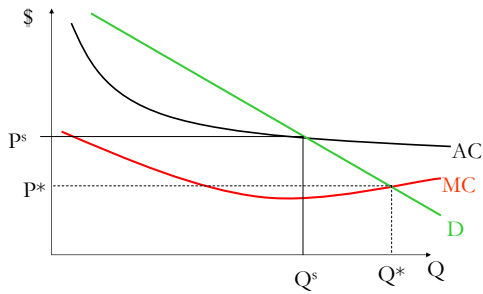
D. Other Problems

1. Implicit income transfer from consumers to investors.
2. Fairness/Quality of Service/Discrimination -- when there's one hamburger joint in town, you can wait for your fries, thank you.
3. Concentration of political power [huge theme in U.S. history]
4. Inefficient standard-setting. If the market for browsers, OS were truly competitive, is it more likely that tech improvements would come along?

Criticisms of the Natural Monopoly Argument

1. Second Best production and pricing are possible. 
2. Price discrimination is possible, so that "last" price charged is arb close to MC.
3. Market power of monopolists is overstated. Substitutes for the firm's product usu exist. (E.g., mail for phone service, Apple for Microsoft, typewriter for MS Word.)
4. Investment needs (esp if investments are irreversible) may dictate supra-MC pricing. 

“Second-Best” Production & Pricing



ROR Reg as Monopoly Remedy

1. Regulator sets or bounds price for firm. Or Reg offers a pricing formula (e.g., firm allowed to price as fraction of K expenditure).
2. Use accompanied by disclosure of firm's assets, costs, etc.
3. Regulator is usually an independent commission.
Justification: Don't want the monopolist to be able to influence rate-setting.

II. Spillovers or Externalities

A. Main Problem: Price doesn't reflect true "social cost" of producing good.

Ex 1: Living next to dairy farm.

Ex 2: Smokestacks, or living downriver of a plant.

Breyer: Anything can be externality, & concept is "useless" unless external value can be somehow monetized.

Bad argument: (1) never defends why monetization is necessary, (2) monetization is least likely precisely where externalities are present. [i.e., monetization part of the bargaining problem.]

II. B. Arguments against Spillovers

1. Coase: under costless bargaining, no problem
 - Dairy farmer can just pay the neighbor the full realized value of breathing the cow crap.
 - Of course, bargaining isn't costless [transaction costs].
2. Property rights can internalize these.
 - But this requires a market for the spillover commodity.
3. No such thing as externalities: neighbor can always move.
 - But of course this is inefficient from Pareto view.

II. C. Classical Solution to Spillovers

1. Measurement and Capping of the "Bad."
 - Measurement is KEY to the solution, both *i/t/o* enforcement and determination of optimum.
 - Capping example: emission limits, or, say, full prohibition of smoking in a public place.
2. Taxation of the "Bad."
 - Solution #1 is an extreme case of this;
 - Example: effluent charges, or grazing fees.

III. Information Asymmetries

A. I have a "lemon" that I want to sell you, but you're uncertain whether it's a good or bad product.

1. Argument is stronger if "failure" or "success" of product/service can be credibly attributed to other processes, mechanisms.
 - E.g., Sheila goes to bad doctor for a cold, or takes bad pill for the flu. She gets better but this would have happened anyway.
 - OR, ... Dale takes a carcinogenic drug and dies, but he had lymphoma to begin with.
2. Two social losses:
 - consumers may pay more
 - (more likely) consumers will consume less, and good firms will be damaged just as much as bad.

III. B. Arguments against Information Asymmetries

1. Market for information always exists.
 - Market for information may not be forthcoming (think of doctors, car salesmen). Audits too costly, ratings unreliable.
 - DISTRIBUTIVE RATIONALE: Even if market available, cost of purchasing information may leave low-income buyers most at risk from fraud. [Some evidence for this proposition.]
2. INTERNET and other media provide information even if their "product" is not commodified.
 - By some accounts, this makes problem worse. Don't know whom to trust.
 - They're often getting information from regulator anyway.

III. C. Customary Solutions to Information Asymmetries

1. SCREENING: Regulator examines products and decides which may enter the market, which not.
2. COMPULSORY DISCLOSURE: State forces firms to disclose certain attributes of product.
3. PRODUCT BANS: Ban some products that fall below some social optimality criterion.
4. (expost) PRODUCT RECALLS. Allow product on to market, pull back when there is suff evidence of hazards, poor quality.
5. CLEARINGHOUSE: Establish state agency as clearinghouse to publicize product failures.

IV. Excessive Competition

- A. Less salient now, but based on 2 concerns.
 - Concern that when new markets open, so many competitors rush in as to inevitably produce waste
 - or produce monopoly
- B. Undergirded CAB, ICC (in part).
- C. Now largely discredited (but wait until the next depression....)
