C34 Lecture 6

Economic Regulation
Historical background

- 1877 *Munn v. Illinois*: establishes powers of state government to regulate activities “affected with the public interest”
- 1886 *Wabash Railroad*: limits state power in interstate commerce, leading to
- 1887 creation of the Interstate Commerce Commission, 1st federal regulatory agency, forerunner to today’s alphabet soup (FDA, EPA, etc.)
- 1930s Great Depression led to FDR’s New Deal and faster growth of federal G regulation
  - FCC, CAB, FAA, FPC, etc.
Legal issue: What activities are “affected with the public interest?”

- *Munn v. Illinois* established the power of the states to regulate prices
- Next half century spent adjudicating limits to this power
- *Nebbia v. New York (1934)* established the principle that “there is no closed class of activities affected with the public interest”
  - G could regulate the prices of any business
- *Federal Power Commission v. Hope Natural Gas (1944)* established that regulated rates must allow a firm to maintain its financial integrity
Positive Theories seek to explain the Why and How of G intervention

• Public Interest Theory (Normative analysis as positive theory)
  – Market failures *caused* G intervention
  – Regulation acts to correct market failures
  – Problem: Too naive

• Capture Theory
  – Regulation resulted from *industry* lobbying
  – Regulations (e.g., price *floors* and entry restrictions) work in the interests of the regulated firms because
    • Regulators later get jobs in industry
    • Organized interest group effect: gains concentrated, losses diffuse
  – Problem: Too many exceptions (e.g., natural gas, public utilities)
Stigler’s Economic Theory

• Politicians/regulators act in their own interest
• Regulation can create producer rents; hence there is a “demand” for regulation that politicians will “supply”
• Predicts
  – Which industries will be regulated (concentrated benefits, diffuse losses)
  – What form regulations will take (entry restrictions)
  – Why politicians tend to be lawyers (facilitates bribes)
U of C modifications to the Economic Theory: Peltzman

• Regulators maximize “political support”
  – Political support depends upon benefits to interest groups
    • E.g., support $M(p,\cdot)$ increasing in industry profit $\cdot$, decreasing in price $p$
  – Predictions:
    • Regulated price between competitive and monopoly prices
    • Monopoly or competitive industries regulated because “gains” greatest
U of C modifications to the Economic Theory: Becker and Posner

- Becker shifted analysis from optimizing choice of politician/regulator to focus directly on strategic choices of interest groups
- Posner: TAXATION BY REGULATION
  - Regulation provides a less visible means of redistributing wealth by pricing some services below cost and prohibiting entry
  - Primary example: Uniform prices, despite higher costs in rural areas
Example: Taxicab regulation

- Why is it necessary to regulate prices and limit the number of medallions?
- How would supply and demand be equated without medallions?
- Wages of taxi-drivers already seem very low. How could deregulation lower prices?
Open question: How to Explain *Deregulation*

- Positive theories rely on creation of rents and rent-seeking behavior to explain regulation
- Deregulation involves systematic destruction of rent-creating mechanisms
  - Elimination of entry restrictions
  - Elimination of minimum price regulations
- Very difficult to explain from the perspective of self-interested regulators/politicians
- Public Interest Theory has no problem with deregulation:
  - Regulation *was* desirable
  - *Now* it isn’t