C50 Lecture 9

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 faste 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 $M(p,p)$ increasing in industry profit $p$, decreasing in price $p$

- Predictions:
  - Regulated price between competitive and monopoly prices
  - Monopoly or competitive industries regulated because “gains” greatest
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