



The Evolution of Regulation 20th Century Lessons and 21st Century Opportunities

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John Stuart Mill, *On Liberty*, 1860

- There is, in fact, no recognized principle by which the propriety or impropriety of government interference is customarily tested. People decide according to their personal preferences. Some, whenever they see any good to be done, or evil to be remedied, would willingly instigate the government to undertake the business; while others prefer to bear almost any amount of social evil, rather than add one to the departments of human interests amenable to governmental control. And men range themselves on one or the other side in any particular case, according to this general direction of their sentiments; or according to the degree of interest which they feel in the particular thing which it is proposed that the government should do; or according to the belief they entertain that the government would, or would not, do it in the manner they prefer; but very rarely on account of any opinion to which they consistently adhere, as to what things are fit to be done by a government. And it seems to me that, in consequence of this absence of rule or principle, one side is at present as often wrong as the other; the interference of government is, with about equal frequency, improperly invoked and improperly condemned.

- A Basic Question:
 - **What rules (aka regulations) should be in place to govern the conduct of individuals and firms and how should these be established?**
- “What these rules should be is the principal question in human affairs; but if we except a few of the most obvious cases, it is one of those which least progress has been made in resolving.”
 - John Stuart Mill
 - *On Liberty*, 1860

Still wrestling with regulatory issues today...

- “The problem is we still have an archaic, 20th-century regulatory system for 21st-century ... markets.”
 - Barack Obama
- “The Supreme Power who conceived gravity, supply and demand, and the double helix must have been occupied elsewhere when public utility regulation was invented.”
 - F.M. Scherer

Where we are headed...

- Deregulation over the past half-century has nominally been driven by the pursuit of **economic efficiencies** and a growing recognition of **imperfections in regulation**.
- But....Ideological changes also played a part.
- But if regulation and deregulation are driven by ideology...policies will be non-discriminating across sectors and mercurial (and non-economic)
- Lessons from history of regulation – “results-based” regulatory policies have been most successful
- Principles of Results-based regulation
- Telecommunication as a case study

Market Governance options: “The Rise of the Regulatory State”



- Merits Free markets rely on supporting institutions
 - Property Rights
 - Rights to redress (litigation)
- Glaeser and Schleifer (JEL, 2003) argue that 19th century US institutions were not strong --- needed direct regulation as *ex post* litigation proved ineffective

The Early Years

- 1887 - 1930s
 - Crises of confidence
- 1930-1960, Stable years
 - Airlines, Telecommunications, Electricity, etc.
 - Entry limited
 - Price, quality regulated
 - Rate-of-return regulation
- Theory:
 - Natural monopoly - An industry in which a single firm is the least cost provider of total market output

The Underpinnings of Change

- Pre-1960s economic concept of regulation
 - 1) Regulators assumed to unwaveringly pursue the public interest
 - 2) Regulatory rules were inviolate
- Together these suggested that regulation acted to promote the public interest

The underpinnings of Deregulation

- But...

- 1) 1962 begins period of scrutiny and skepticism of regulation...

“The literature of public regulation is so vast that it must touch on everything, but it touches seldom and lightly on the most basic question one can ask about regulation: Does it make a difference in the behavior of an industry? This impertinent question will strike anyone connected with a regulated industry as palpably trivial. Are not important prices regulated? Are not the routes of a trucker and an airline prescribed? Is not entry into public utility industries limited? Is not an endless procession of administrative proceedings aging entrepreneurs and enriching lawyers? **But the innumerable regulatory actions are conclusive proof, not of effective regulation, but of the desire to regulate.**”

George J. Stigler and Claire Friedland

“What Can Regulators Regulate?” (*J.Law & Econ.*,1962)

The Growth of “The Chicago School”

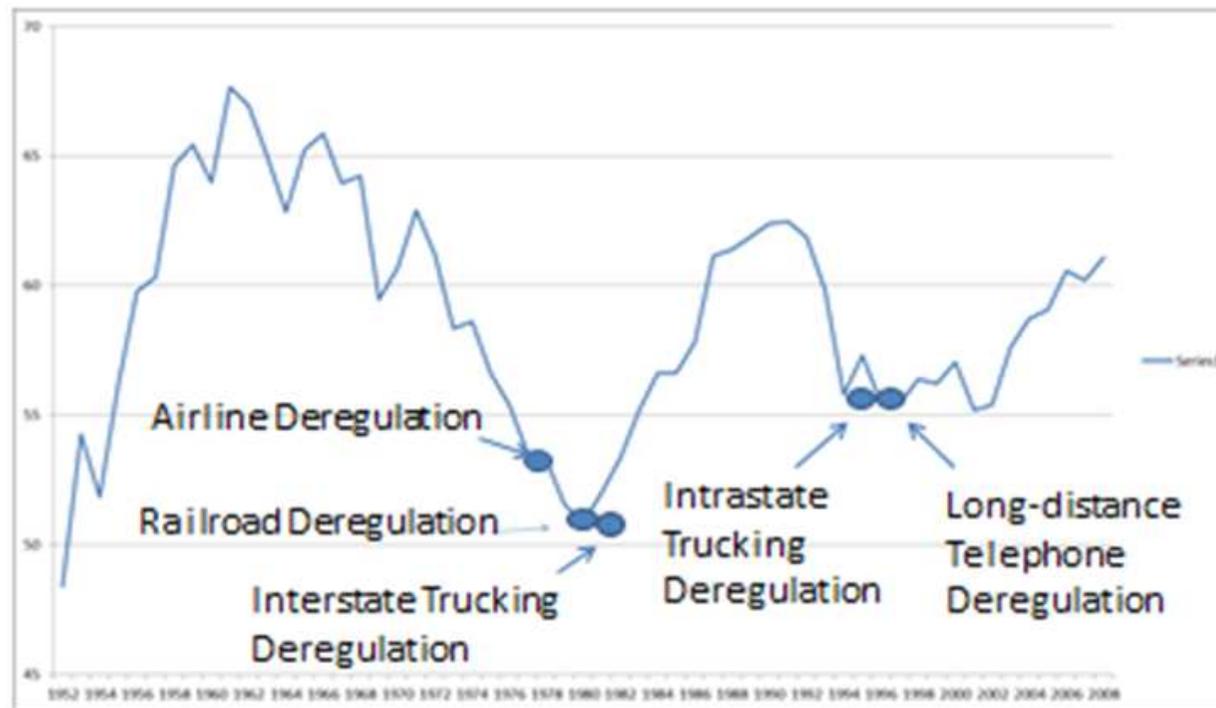
- Stigler (1971) “The Economic Theory of Regulation”
 - “as a rule, regulation is acquired by industry and is designed and operated primarily for its benefit.”
 - Subsequent, contributions from Peltzman, Posner and Becker
 - More general lesson ..regulatory outcomes are the product of the supply of, and demand for, regulation
 - **Highlights the strengths of interest groups as driver of regulatory outcomes...regulation is imperfect.**
- Chicago approach risks: (1) seeing regulation solely as a political outcome, devoid of economic merit (2) **being kidnapped into a position that aligns too easily with**

Ideological drivers

- (2) the complementary role of ideology
- “the [debate over the] nature and limits of the power which can be legitimately exercised by society over the individual.... is so far from being new, that, in a certain sense, it has divided mankind, almost from the remotest ages.”
- “A question seldom stated, and hardly ever discussed, ...[it] profoundly influences the practical controversies of the age by its latent presence,”
- John Stuart Mill,
- *On Liberty*, 1860

The Ideological “mood” of the American People

DRAFT -Figure 1
The Ideological Mood of the American People
and the Deregulation Movement



Going forward

- While informative, neither the Chicago School nor the Ideological perspective are particularly useful going forward...
 - Chicago approach: A positive theory of regulation which reveals that regulation is flawed ... but so are all market governance mechanisms ...so we cannot turn positive theory into a normative driver of policy
 - Ideology
 - Open to fickle and non-discriminating policy

Results-Based Regulation

- Airlines - Michael Levine (*Yale Law Journal*, 1965)
 - Concludes that deregulation is in public interest
 - Interstate (regulated) v. Intrastate (deregulated)
 - Rates were 215 percent higher in interstate markets
- Long Distance Telecommunications
 - Intrastate v. interstate
- Intrastate Trucking
 - Before-and-after
 - Florida natural experiment

- President Obama: a policy goal of the present administration is to
 - “root out regulations that conflict, that are not worth the cost, or are just plain dumb.”
 - How can we tell if a set of regulatory constraints is “just plain dumb?”

RBR Principles

- Principle 1 – All market governance mechanisms for resource allocation are, in practice, imperfect.
 - Imperfect market v. perfect regulation
 - Imperfect regulation v. perfect market
- Principle 2 – Given the imperfections of alternative governance mechanisms, advances in technology and presence of evolving legal institutions, regulators must be vigilant to the possibility of improved regulatory or deregulatory designs.
 - Cautions against regulatory inertia (telecommunications, electricity)
 - Complementary evolution of legal institutions

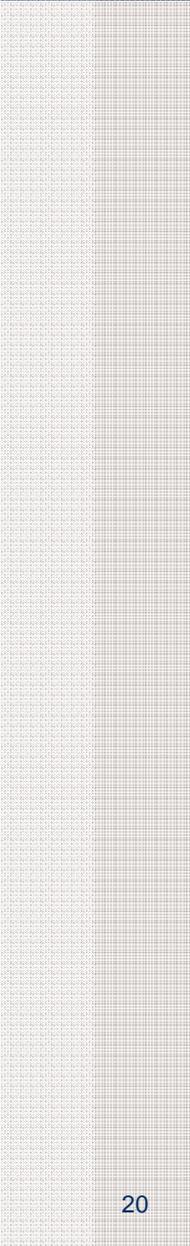
RBR Principles (cont.)

- Principle 3 – Wherever possible, regulators should engage in empirical counterfactual scrutiny of alternative market governance mechanisms.
 - Different market governance mechanisms
 - Different jurisdictions (states, states v. fed. Govt., other countries)
- Principle 4 – In assessing the merits of alternative market governance mechanisms, policymakers should heavily weight granular empirical evidence collected from actual markets.
 - High level economic theorizing has a place, but empirical assessment of actual behaviors trumps (e.g. HHI)

- Principle 5 – When considering alternative governance structures for a market, policymakers should focus on tangible, end-state economic metrics
 - Best RBR policies have focused on retail economic metrics (price, output, investment and innovation) rather than loftier and more elusive “public interest” goals
 - Caution: Low priced rail rates -“Standing derailments” and “residually priced” local telephone
 - Weights to metrics will vary (e.g., need to invest is critical to broadband)

President Barack Obama

- “This is the lesson of our history: Our economy is not a zero-sum game. Regulations do have costs; often, as a country, we have to make tough decisions about whether those costs are necessary. But what is clear is that we can strike the right balance. We can make our economy stronger and more competitive, while meeting our fundamental responsibilities to one another.”



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