Economics and Regulation: Have We Learned the Wrong Lessons?

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Ninth ACCC Regulatory Conference
Revisiting the rationale for regulation
Gold Coast, Queensland, 25 July 2008

The views expressed are not those of the U.S. Department of Justice.

4 Unreliable Lessons

- 1. Profit margins tell us something about monopoly power.
- 2. Regulators and antitrust enforcers should ignore distributional considerations.
- 3. Price caps are good. Rate-of-return regulation is bad.
- 4. Vertical separation is the way to create competition in network industries.

1. Profit margins tell us something about monopoly power.

- Define: Profit margins = (TR – VC)/TR
- 1. This is not what entrepreneurs or investors maximize.
- 2. In LR equilibrium this must be positively related to industry capital intensity (i.e. rK/TR).

Profit margins, cont.

- 3. The Lerner equation relates elasticity of demand to *MC*, not VC.
- 4. Theory shows that in LR equilibrium, P = *MC*, not VC.
- 5. When enforcement requires us to dig deep, VC is often a poor proxy for MC.
  - Traditional measurement issues (Fisher)
  - Predatory pricing
  - Wholesale electricity markets
  - Critical loss analysis

2. Regulators and antitrust enforcers should ignore distributional considerations.

- Traditional rationales:
  - Impermissibility of interpersonal utility comparisons
  - “Division of labor” among policy instruments
- But there are exceptions
  - Public finance and the “Frisch parameter”
  - Political science and models of voting and parties
- And “division of labor” may beg the question

Distribution, cont.

- In US and other countries, income distribution is becoming more unequal
  - Especially, ownership of both stocks and bonds
- Thus transfers from buyers of goods to shareholders and bondholders on average regressive

Distribution, further cont.

- “Intermediate goods”
  - Extensive literature on pass-through
- Does this mean that monopsony is OK?
  - ANOTHER wrong lesson: “Even monopolists pass along cost reductions”
- Sometimes it’s pretty clear
  - Sympathetic plaintiffs and prosecutorial discretion

3. Price caps are good. Rate-of-return regulation is bad.

- High powered vs. low powered incentives
  - A spectrum: information revelation vs. allocative efficiency
  - Inability of governments to commit
- Especially: developing country applications
  - Other priorities besides pure efficiency: attracting investment, increasing coverage, insuring against future expropriation

4. Vertical separation is the way to create competition in network industries.

- Two issues that were under-appreciated
  - Potential for competition and competitive outcomes in “competitive” sector
    - Railways: Economies of density
    - Electricity: Repeat games and inframarginal rents
  - Loss of economies of vertical integration
    - Railways: “Where steel meets steel”
    - Electricity: New regulatory/coordinating institutions
- Public utilities restructuring vs. Transactions cost economics: Ships passing in the night?

For further reading…

- “Electricity Restructuring in China: The Elusive Quest for Competition” (with Vanessa Yanhua Zhang), EAG Discussion Paper 08-5, April 2008
- “Consumer Surplus as the Appropriate Standard for Antitrust Enforcement,” *Competition Policy International* 3 (2007), 205-224
- “Make or buy on the Russian railway? Coase, Williamson, and Tsar Nicholas II,” *Economic Change and Restructuring* 40 (2007), 207-221
- “Competition in Freight Railways: ‘Above-the-Rail’ Operators in Central Europe and Russia” (with 4 co-authors), *Journal of Competition Law and Economics* 3 (2007), 673-687.
- “Options for Restructuring the State-Owned Monopoly Railway,” in Dennis and Talley, *Railroad Economics* (Research in Transportation Economics 20), 2007
- “Restructuring the Russian electricity sector: Re-creating California?”, *Energy Policy* 35 (2007), 1872-1883.
- “Structural Separation to Create Competition? The Case of Freight Railways,” *Review of Network Economics* 4 (2005), 181-196.
- “Russian Railways Reform and the Problem of Non-Discriminatory Access to Infrastructure,” *Annals of Public and Cooperative Economics* 75 (2004), 167-192.
- “Chinese Railway Reform and Competition: Lessons from the Experience in Other Countries,” *Journal of Transport Economics and Policy* 38 (2004), 309-332.
- “Vertical restructuring (or not) of the infrastructure sectors of transition economies,” *Journal of Industry, Competition & Trade* 3 (2003), 5-26.