Economics and Regulation: Have We Learned the Wrong Lessons?

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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