

The Economics and Politics of Regulation

A Behavioral Approach

Douglas Needham

THE ECONOMICS AND POLITICS OF REGULATION A Behavioral Approach

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Preface

In this book I attempt to overcome a number of weaknesses in currently available textbooks on government regulation. Some books dealing with government policies toward business tend to be focused mainly on the institutional and legal aspects of these policies. Other books that are more analytical and attempt to present the economic theory underlying government regulation suffer from incomplete presentations of the reasons for regulation, of the issue of whose goals are served by regulation, and of the effects of regulation on all members of society.

I adopt a broad behavioral approach, focusing on the determinants of people's perceptions and evaluations of regulation's effects. This approach is used to develop a framework that integrates a number of factors underlying the existence and effects of government regulation that are often either omitted or treated separately in the literature.

This book is intended to serve the needs of upper-level undergraduate and introductory graduate courses dealing with government regulation of business in colleges and universities, business schools, and law schools. It also provides a comprehensive, forward-looking overview of the determinants and effects of government regulation that will prove useful for professionals actively engaged in the regulatory process, including government officials, regulators, lawyers, business people, and other types of decision makers confronted by government regulations.

Familiarity with elementary principles of microeconomics will be helpful to the reader but is not mandatory, because the book has been made as self-contained as possible. A number of recent developments in the professional economics literature, connected with incentive systems, distributional considerations in cost-benefit analysis, and methodology of economic analysis, have been integrated into the book. These developments are explained and diagrams are provided when their use will enhance the reader's understanding. Symbols are used only occasionally to summarize relationships among the factors discussed. Carefully selected reference works for each chapter are provided in the References preceding the Index, to permit instructors and readers to deal with individual topics in greater depth. When the book is used at the graduate level, it should be extensively supplemented by these works.

Two major elements of all government regulations are welded together in this book: the "politics" of regulation, emphasizing whose

interests are served and the process that produces regulation; and economic analysis of the complex set of factors that determines the effects of regulation on regulated and unregulated segments of society.

These include, for example, individuals, regulated and unregulated; interest groups; legislators; regulators; and organizations; all are participants in the regulatory process. Their behavior jointly determines the nature and effects of regulation. I explain both the manner in which the behavior of these groups is related and the implications of these relationships for the form and effects of regulation.

Participants in the regulatory process operate in an environment that shapes their individual and collective behavior. This environment includes a number of constraints, including personal ideologies and values, limitations on available resources, an inherited institutional structure, and uncertainty about the effects of existing and proposed regulations. These and other constraints jointly influence the behavior of the participants in the regulatory process. When their implications for the form and effects of regulation are considered, they must therefore be viewed jointly, rather than separately. Such a view is achieved by the framework presented in this book.

Government regulation is only one type of instrument that individuals may use to further their aims. A myopic focus on government regulation of business alone fails to capture the range of possible substitute instruments available to governments and individuals and does not provide a suitable framework either for understanding people's choices among instruments or for evaluating them. This book provides a framework for understanding and evaluating alternatives to regulation.

The unifying framework presented in this book is important. The behaviors of participants in the regulatory process are interrelated and cannot be satisfactorily analyzed separately. Also, different types of regulation are related to each other. These relationships exist both on the demand side of regulation, owing to factors linking the types of regulation demanded by various interest groups, and also on the supply side of regulation, owing to factors linking the behaviors of regulatory agencies and regulated firms. It will be shown that failure to take account of these interactions among different types of regulation underlies many failures of current types of regulation to achieve their intended objectives.

The traditional tools of economic analysis also need to be broadened in several ways. For example, the weights that participants in the regulatory process attribute to people's evaluations of regulation's effects need to be explicitly considered in both descriptive and normative analyses of regulation. Also, people's evaluations should be viewed as endogenous, or variable, rather than as fixed factors, for several related reasons. For example, evaluations of regulations are influenced by information regarding its effects from a variety of sources, and this information can change; and experience with regulation may indicate that its effects are different from those anticipated.

Another major reason for viewing evaluations of regulation as variable is connected with the distinction between subjective and revealed evaluations. In a satisfactory analysis of government regulation, it must be explicitly recognized that revealed and subjective evaluations may differ. This difference applies to all participants in the regulatory process — to regulators and interest groups as well as to regulated decision makers. If revealed and subjective evaluations are not the same, the normative significance that can be placed on revealed evaluations is severely limited.

Revealed evaluations constitute a tool that people employ to further their objectives. The extent to which individuals will honestly reveal their subjective evaluations depends on the incentives that confront them, because this will determine the consequences of honest versus misrepresented revelations of preferences. These incentives, and hence the nature of revealed evaluations, depend in part on the form of existing regulatory constraints. Examination of the types of incentive that motivate people to reveal their evaluations and other kinds of information truthfully are relatively recent in the professional economics literature. Because they are crucial in a satisfactory normative analysis of regulation, these developments are integrated into the analytical framework employed in this book.

Another dimension that needs to be added to traditional economic analyses of regulation is the disequilibrium behavior of participants in the regulatory process. Owing to uncertainty regarding the outcome of any type of regulation, participants will not generally be able to immediately adopt forms of behavior that simultaneously achieve all their respective goals or targets. The disequilibrium behavior rules the participants adopt whenever their targets are not being achieved will influence the ensuing time path of the behavior of all the participants.

Trade-offs are unavoidable, and the omission from this book of detailed consideration of historical, institutional, and legal material on various types of government regulation is not intended to minimize the possible importance of these factors as an influence on the conduct of regulation in practice. To obtain a clear understanding of the causes and consequences of regulation in practice, however, a flexible analytical framework that shows how the many dimensions of regulation are related, and the process that generates them, is indispensable. This kind of framework affords a perspective on the conflicting perceptions and value systems that permeate issues in regulation. The solution to any problem depends on the manner in which the problem is formulated; many issues in regulation are connected with the problem-formulation stage, and can be properly understood only within a flexible analytical framework.

I would like to thank a number of persons whose efforts contributed to the completion of this project. Lee E. Preston, University of Maryland, read an earlier version of the manuscript and made many constructive suggestions for improving the exposition. Bruce Caldwell, University of

North Carolina, provided enlightening discussions on methodology in the social sciences, and reviewed Section 2.4, which deals with methodology and theory choice. Others who read all or part of the manuscript and made constructive comments were W. Bruce Erickson, University of Minnesota, and Kevin C. Sontheimer, University of Pittsburgh. Ruth Turner performed miracles typing the manuscript under severe time constraints. Naturally, responsibility for the final form of the book is solely mine, including any deficiencies that may remain. The permission of Holt-Saunders Ltd. to include material from my book, *The Economics of Industrial Structure, Conduct and Performance* in two sections of Chapters 8 and 9, and permission of the *American Economic Review* and William A. Niskanen and Thomas C. Schelling to include material is also gratefully acknowledged.

It is hoped that readers of the book will find the issues related to government regulation as stimulating and challenging as the author does.

Douglas Needham

IN MEMORIAM
Douglas Needham
Born 1940 Died 1982

Doug Needham died on August 13, 1982. He had completed the bulk of the work on this book before his untimely death.

My small contribution to this work was to read the galley proofs, make some minor, technical corrections, and prepare the index. In reviewing Doug's work I tried to put myself into his Weltanschauung and make only the minimum of changes, so that his ideas were not altered in a substantive way.

Doug had a very fertile mind and never stopped subjecting ideas, whether conventional wisdom or his own novel views, to constant examination. To improve our understanding of public policy issues in general and regulatory issues in particular was a never-ending quest for him. His objective shines through in this and his other published works. It was also an outlook that he successfully transmitted to students. The profession and his students will sorely miss his presence.

John C. Wassom
Western Kentucky University

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CHAPTER ONE

Introduction

1.1 REGULATION IN THE UNITED STATES

The term “regulation” can be defined in many ways. Any definition will influence one’s conceptualization of what is meant by regulation and how it relates to other factors. Attempts to measure characteristics of regulation will produce results that depend on the way the term is defined. Assumptions about the nature of regulation will influence the conclusions anyone reaches when thinking about regulatory issues.

Although regulation takes many forms, and has varying characteristics, it generally involves a conscious attempt by an individual or a group to influence the behavior of other individuals or organizations. The fact that regulation attempts to restrict people’s behavior does not necessarily imply that the restrictions are unwarranted or undesirable. Most people agree that governments should impose restraints on human conduct in such forms as laws against theft, violence and murder, fraud, and similar activities. There is less agreement on the desirability of other types of regulation, including restraints on business activities. One’s views on the desirability of any type of regulation depend in part on the perceived objectives regulation is designed to achieve, and these perceived objectives can vary greatly (see Section 1.2). One’s views may also be influenced by the type of regulatory instruments employed, such as monitoring and enforcement activities, penalties, rewards, or other types of remedy employed by regulatory agencies, such as licensing, certification, or inspection. The concept of regulation as a restraint on people’s behavior must not be confused with the objectives or instruments of regulation, though all three aspects of regulation are related and are needed in understanding and evaluating regulation. The major focus of this book will be upon the decision-making process of individuals and the implications of regulatory constraints for their behavior. The many characteristics of government regulation are linked via the process of decision making by individuals who demand government regulation, legislators and regulators who formulate and administer regulations, regulated decision makers, and

unregulated decision makers who are indirectly affected by regulation. The interactions among these decision makers result in the process that creates government regulation and its effects.

Although this book focuses on government regulations aimed at the behavior of business enterprises in the United States, the methodology employed and many of the major conclusions reached can also be applied to other types of government regulation. Moreover, it is not always possible to separate different types of government regulation: all types of government regulation — all laws, taxes and subsidies, and many government activities not usually considered as regulation — are functionally equivalent in the sense that they influence the opportunities, consequences, penalties, and rewards associated with alternative courses of action considered by decision makers. Individuals' behavior will depend on *all* the government regulations and other types of constraint that collectively determine the opportunity set confronting each individual decision maker. Regulations aimed at business behavior will also generally affect other dimensions of people's behavior; for example, regulations that affect individuals' incomes may affect their childbearing behavior. Similarly, regulations aimed at other areas of people's behavior may affect business behavior. Thus, criminal laws prohibiting kinds of behavior such as marijuana growing and prostitution may channel human activities into economic activities of a more (or possibly less) socially acceptable kind. Regulations affecting political campaign spending, the geographic boundaries of legislative districts, and other aspects of political behavior may also have implications for business behavior. These political constraints are often intimately connected with factors underlying legislators' behavior and the type of regulatory legislation that is enacted.

Just as government regulation of business behavior consists of only a portion of government regulations, "government" regulations, which are given legislative sanction, constitute only a portion of the regulations that confront individuals and organizations. Ethical and moral codes of conduct associated with people's religious beliefs, professional affiliation, social customs, and other behavioral restraints often deeply affect the way people behave. Although the institutions and organizations involved in the creation and enforcement of these codes of conduct differ from government, the methodology employed in this book and many of the conclusions that apply to government regulations affecting business behavior can also be applied to these other types of restraint. Human behavior depends on the *joint* effect of all these restraints and regulations. This fact is extremely important; the effects on behavior of any particular type of regulatory constraint will generally depend on, and vary with, differences in other existing types of restraint on people's behavior.

Even when the type of regulation we are considering is limited to government regulation of business behavior, a meaningful idea of the scope and magnitude of this type of regulation in the United States is

difficult to grasp. Government regulation of business takes many forms; each form has many dimensions; and there are correspondingly many possible measures of its scope and magnitude. One measure is the number of regulations directed at businesses that are listed in the Federal Register, which contains the rules and regulations promulgated by federal agencies. In the almost forty-year period between 1937, when federal agencies were first required to publish their regulations in the Register, and 1975, the size of the Register expanded from approximately 3,400 pages to more than 60,000 pages. A quarter of this increase occurred between 1974 and 1975 alone. The accelerated expansion of the Federal Register continued until the Reagan administration instituted measures to deregulate aspects of a few selected industries.

State and local government regulations aimed at business behavior must also be taken into account to gain a proper perspective over the extent of regulation. These regulations have tended to exhibit growth similar to that of federal regulations. The expansion in federal and state regulation of business behavior is related (see Chapter 11). To a considerable extent, such growth reflects conscious and unconscious competition among regulatory agencies intent on enforcing their own regulatory constraints on different facets of business behavior.

The growth in the number of government regulations actually understates the growth of regulation because it neglects the greater detail and complexity of regulations added in each successive time period. Again, this increased complexity often reflects attempts by regulatory agencies to enforce their regulations successfully and to prevent the frustration of the desired effects of their regulations by the response of regulated decision makers and other regulatory agencies. McKie (1960) has aptly called this the "tar-baby effect" of regulation, since it usually entangles the regulatory agency in control efforts of increasing complexity with little impact except a growing feeling of frustration on the part of the regulators.

Another way to measure the extent of regulation is to list all the regulatory agencies, and their budgets or number of employees, or some other index of the agencies' size. This requires a definition of the term "regulatory agency," which is not difficult in the case of agencies that perform only regulatory functions, such as the Interstate Commerce Commission, Civil Aeronautics Board, Securities and Exchange Commission, Federal Trade Commission, Consumer Product Safety Commission, Environmental Protection Agency, Food and Drug Administration, Equal Employment Opportunity Commission, and Federal Communications Commission. These are only a sample of the many government agencies that specialize in administering and enforcing regulations. It is more difficult to draw a line between regulatory agencies and other types of government units in the case of agencies that perform both regulatory and other functions. For example, in addition to its other functions, the

Department of Labor administers employment and job safety standards; the Department of Agriculture administers food inspection programs; and the Department of Justice, the Treasury, and the Internal Revenue Service each has mixed regulatory and nonregulatory functions. Many agencies with mixed functions have larger budgets and allocate more of their budgets to regulatory functions than do agencies that specialize in regulation.

Table 1.1 lists the major federal regulatory agencies. The number of such agencies, their budgets, and the number of their employees have grown at an accelerating pace in recent years. Weidenbaum (1981) has estimated that between 1974 and 1980 the combined operating expenses

Table 1.1. Federal Regulatory Agencies

I. Agencies Specializing in Regulatory Functions

Civil Aeronautics Board
 Commodity Futures Trading Commission
 Comptroller of the Currency
 Consumer Product Safety Commission
 Environmental Protection Agency
 Equal Employment Opportunity Commission
 Federal Communications Commission
 Federal Deposit Insurance Corporation
 Federal Energy Regulatory Commission
 Federal Trade Commission
 International Trade Commission
 Interstate Commerce Commission
 National Labor Relations Board
 National Transportation Safety Board
 Nuclear Regulatory Commission
 Securities and Exchange Commission

II. Agencies with Regulatory plus other Functions

Department of Agriculture
 Department of Commerce
 Department of Defense
 Department of Energy
 Department of Human Resources (formerly Department of Health, Education, and Welfare)
 Department of the Interior
 Department of Justice
 Department of Labor (Occupational Health and Safety Administration)
 Department of Transportation (National Highway Traffic Safety Administration)
 Department of the Treasury

of the major federal regulatory agencies increased from \$2.8 billion to \$6 billion, while those agencies' total employment increased from approximately 66,000 to more than 80,000 employees in the same period. Moreover, regulatory agencies have been growing not only in absolute terms but also in terms of the fraction of total economic activity they occupy, measured either as a fraction of the gross national product produced in regulated industries or in terms of the total labor force employed in regulatory agencies.

The budget figures understate the great extent of the total costs of administering federal regulations, because much of the cost of providing information to regulatory agencies is borne by individuals and organizations in the private sector. In a report published by the comptroller general of the United States in 1978 it was estimated that businesses alone expended 69 million hours annually at an estimated cost of more than \$1 billion to respond to more than 2,100 federal reporting requirements, excluding IRS forms. The same report cites an IRS estimate that its reporting and recording requirements result in some 613 million hours of effort by businesses and individuals. Another report by the U.S. Commission on Federal Paperwork (1977) estimated that whereas the burden of federal government paperwork cost the government \$45 billion in 1977, the total cost including the burden placed on individuals and businesses amounted to \$100 billion, or about \$500 for each person in the country. These figures and estimates apply only to federal regulatory agencies.

Still another way to measure the scope of regulation is to focus on individuals and organizations whose behavior is regulated. Variants of government regulation of business have existed at least since medieval times, when European rulers granted charters containing rights and obligations to individuals and organizations engaging in shipping and other trades. In contrast, regulation of business activities is a relatively recent phenomenon in the United States. Although some limited forms of local regulation existed in the early 1800s, the origin of federal regulation of business on a national scale dates back only to the creation of the Interstate Commerce Commission in 1887. Creation of the ICC was in part a response to the growth of the monopoly power of transcontinental railroads, but it also received support from eastern railroads anxious to limit price competition in the railroad industry. The ICC's jurisdiction over interstate railroad rates and service was later extended to include control over rates and entry into highway transportation.

The passage of the Sherman Act in 1890 marked the beginning of federal regulation of monopoly and competition in the United States. Chapters 6 and 7 explain why regulation of monopoly and competition by agencies such as the Federal Trade Commission and Department of Justice can be viewed as a form of regulation. In markets and industries where monopoly was considered to be unavoidable or desirable for efficiency or other reasons, federal, state, and local governments often