

Economics of Regulation and Antitrust

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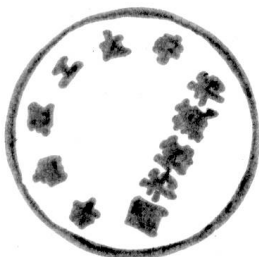


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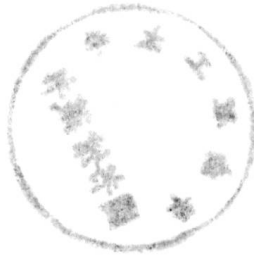
ECONOMICS OF REGULATION AND ANTITRUST

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This book is dedicated to:
Kira and Michael
Michelle, Julie, John, and Chris
Joe and Kathryn

Preface

Regulation and antitrust policies have become critical ingredients of our national economic policy. The principal mechanisms of government intervention include not only taxes and spending but also more direct effort to control the operation of markets. Although the degree of government influence varies across markets as well as over time, the extent of government intervention has remained quite pervasive even in the wake of selected deregulation efforts.

The traditional emphasis of economic textbooks on business and government is on the character of regulations and antitrust policies. What are these policy mechanisms, and how do they operate?

The orientation of *Economics of Regulation and Antitrust* is quite different. Rather than starting with the institutional aspect of regulatory and antitrust policies, we begin with the economic issues at stake. What particular market failures provide a rationale for government intervention? How can economic theory illuminate the character of market operation, the role for government action, and the appropriate form of government action? What do formal empirical analyses of economic behavior and the effects of government intervention indicate about the direction that this intervention should take? To provide the most up-to-date answers to these important questions, we base our analysis on new developments in economic theory and empirical analysis that have been specifically devised to further understanding of regulations and antitrust policies.

Because this has been a fertile area of economic research for several decades, a large body of economic reasoning can be brought to bear in analyzing these issues. *Economics of Regulation and Antitrust* is the only economics textbook whose focus derives from the insights that economic reasoning can provide in analyzing regulatory and antitrust issues. This approach contrasts with previous treatments, which concentrate on the character of these policies and relegate the economic issues to a minor role.

This emphasis on economics in no way implies a neglect of the pertinent institutional features. This text includes extensive case studies of major areas of regulation and antitrust policy, including entire chapters devoted to such issues as government merger policies, cable television regulation, and transportation regulation. Indeed, this text is unique in its extensive coverage of several of these topics, as well as issues such as the role of the White House regulatory oversight process. Although this book

discusses essential aspects of these regulations and their performance, our intent is not to provide students with a list of case names, government rules, and other institutional details. Rather, we hope to provide students not only with pertinent insights today but also with the economic tools to analyze the implications of regulations and antitrust policies a decade from now. Future policies may have a quite different structure from those presently in place, and it is the economic framework we use to approach these issues that will be of lasting value.

The minimum economics background needed for this book is an introductory price theory course. This background will enable students to grasp all of the empirical material as well as most of the theoretical developments. In some cases, the text advances to a level at which some background in intermediate microeconomic theory is desirable, but these more difficult sections can be omitted. A unique feature of this book is that it brings to bear on these issues new developments in industrial organization and game theory. Presentation of this more advanced material is self-contained, does not involve the use of calculus, and is incorporated in chapters in such a way that it can easily be omitted by an instructor with a different course emphasis.

We have used drafts of this book in our teaching at the undergraduate level and in business school curricula. In no case did we use all of these chapters in any one course. Although the book's coverage is somewhat encyclopedic, it is still not all inclusive. It is doubtful whether any single course can successfully cover all of the material included in this book, except perhaps in an intensive two-semester sequence. Because instructors have a variety of different interests and instructional needs, we have structured the book in a manner that will facilitate its use in a variety of contexts.

Organization of the Book

Economics of Regulation and Antitrust consists of two introductory chapters, followed by three parts. The beginning of the book sets the stage and introduces some of the overriding issues, such as ascertaining what the objective is that government regulators maximize and considering the appropriate division of labor between the states and the Federal government.

The following three parts of the book present the core of the analytical material. Part 1 focuses on antitrust policy, Part 2 deals with economic regulation, and Part 3 focuses on social regulation. Each of these parts is structured in a similar manner. The first chapter of each part provides an overview of the key economic issues as well as the pertinent methodology that will be employed. We discuss the principal market failures in this context, and how economic analysis is used to address them. In every case, the first chapter of each part can be viewed as essential reading. The instructor can then select which of the subsequent case studies to use. Chapters that require the student to have read another chapter within that part, other than the introductory chapter, are noted below. Otherwise, chapters within a part can be assigned in whatever order the instructor wishes. Any chapters that the instructor wishes to omit may be excluded.

Part 1, which focuses on antitrust policy, includes a healthy dose of the analytical tools of modern industrial organization. Chapter 3 is an introductory overview of antitrust policy and of the other chapters in Part 1. Efficiency and technical progress are explained in Chapter 4 as tools for evaluating policies. At least the first half of this chapter is probably necessary reading for understanding Chapters 5–9.

Oligopoly and collusive pricing (Chapter 5) is novel in introducing oligopoly through a game theoretic approach and then relating the theoretical models to antitrust cases. Market structure and entry deterrence (Chapter 6) is mostly analytical; it can be skipped by instructors under time pressure in courses with a primary focus on antitrust cases. The remaining three chapters—horizontal and conglomerate mergers (Chapter 7), vertical mergers and restrictions (Chapter 8), and monopolization and price discrimination (Chapter 9)—are “stand-alone” chapters that can be assigned or not depending on the instructor’s preference.

Part 2 addresses the role of economic regulation. As evidenced by the dozen or so case studies in this part, economic regulation has been an integral part of the U.S. economy. Although there has been substantial deregulation of airlines, trucking, and long distance telephone, the debate over appropriate regulatory policies and re-regulation is still very active.

An overview of economic regulation, including its historical development and a summary of regulatory practices, is provided in Chapter 10. This chapter also provides the most in-depth textbook discussion of the efforts of social scientists to understand the extent of government regulation. The remainder of Part 3 is comprised of two pieces. Chapters 11–15 cover the regulation of natural monopolies. The recent theory of natural monopoly is presented in Chapter 11, while Chapter 12 reviews actual regulatory practices with respect to electric utilities and local telephone companies. Although regulation is the standard U.S. government response to natural monopolies, alternatives are available; these are discussed in Chapters 13 and 14. Chapter 13 addresses a new and promising approach, franchise bidding, and provides a detailed case study of cable television. A more traditional alternative is that of government enterprise. It is reviewed in Chapter 14, along with a comparative analysis of government ownership and regulation with respect to electric utilities. Then, in Chapter 15, some dynamic issues related to monopoly regulation are explored in the context of the rapidly changing long-distance telecommunications market.

The regulation of markets that are potentially competitive receives in-depth treatment in the remaining three chapters of Part 2. A theoretical investigation of the effects of regulation is provided in Chapter 16. These ideas are then applied to regulation in the transportation and energy industries. Chapter 17 closely examines airlines and surface freight transportation (in particular, trucking and railroads), while Chapter 18 covers the crude oil and natural gas industries.

Part 3 focuses on the new forms of risk and environmental regulation that emerged primarily after the 1970s. Chapter 19 introduces the principal methodological issues, including market failures such as externalities and inadequate risk information, the primary economic test of benefit-cost analysis that applies in this area, and

the rather daunting task that economists face in assigning dollar values to outcomes such as a five-degree temperature change in the early part of the next century.

The task of assigning market prices to outcomes that, by their very nature, are not traded in efficient markets is the focus of Chapter 20. The primary case study concentrates on how economists attempt to assign a dollar value to risks to human life, which illustrates how economists have attempted to assess the pertinent tradeoff rates that should be used in evaluating government policies. The next three chapters deal with various types of social regulation policies, including environmental protection regulation (Chapter 21), occupational safety regulation (Chapter 22), and product safety regulation (Chapter 23). Chapter 23 presents the greatest variety of issues that have been of long-term interest to researchers in industrial organization and in law and economics. A major strength of all these chapters is that they confront the current policy issues now under debate, including topics such as global warming and the role of product liability law.

Suggested Course Outlines

An intensive one-year course could cover this entire book. However, in most cases, instructors will be using the book in a context in which it is not feasible to cover all the material.

In Table A we have identified six different course approaches and the pertinent chapters that can be assigned for each one. The first type of course is the balanced one-quarter course. Such a course would include the introductory material in Chapters 1 and 2 as general background; Chapters 3–5, 7, and 9 from Part 1; Chapters 10 and 12 from Part 2; and Chapters 19, 20, and 23 from Part 3.

The second course approach is a conventional antitrust course. It would place the greatest reliance on Part 1 of the book, which includes Chapters 3–9. Instructors who wish to provide a broader perspective on some of the other topics in regulation might augment these chapters with the indicated chapters for the one-quarter course.

A course focusing on economic regulation would include primarily the introductory section and Part 2 of the book, or Chapters 1–2, 4, 10–18, and 23. Similarly, a course focusing on social regulation, would include the introductory section and Part 3 of the book, or Chapters 1–2, 4, and 19–23. In situations in which we have taught such narrowly defined courses, we have often found it useful to include the material from the balanced one-quarter course as well, to give the student a broader perspective on the most salient economic issues in other areas of government intervention.

Given the frontier treatment of industrial organization in Part 1, this book could also be used in a policy-oriented course on industrial organization. With Chapters 3–6 providing the theoretical foundation in industrial organization, an instructor could select from the remaining chapters to cover a variety of policy issues. A suggestion is to use Chapter 9 (its coverage of monopolization practices follows up on the theory of strategic entry deterrence in Chapter 6), Chapters 10, 13, and 16–18 (to examine how different types of economic regulatory structures can affect competition), and Chapter 23 (to assess efforts such as product quality regulation).

Table A SUGGESTED COURSE OUTLINES

COURSE FOCUS	CHAPTER																						
	Introduction			Part 1							Part 2							Part 3					
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23
Balanced one quarter course	✓	✓	✓	✓	✓		✓		✓	✓		✓							✓	✓			✓
Antitrust			✓	✓	✓	✓	✓	✓	✓														
Economic regulation	✓	✓		✓						✓	✓	✓	✓	✓	✓	✓	✓	✓					✓
Social regulation	✓	✓		✓															✓	✓	✓	✓	✓
Industrial organization			✓	✓	✓	✓			✓	✓			✓			✓	✓	✓					✓
Institutional	✓	✓	✓		✓		✓		✓	✓		✓							✓	✓	✓	✓	✓

The final course outline pertains to courses, particularly those in business schools, that wish to have a more institutional focus. For these courses, the objective is to focus on the empirical aspects of government regulation and antitrust policies, as well as the character of these policies. Moreover, these courses would require no advanced undergraduate economic methods. The chapters in the book that meet these tests and can be readily grasped with an introductory economics background are also indicated in Table A.

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**ECONOMICS OF
REGULATION
AND
ANTITRUST**

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