Chapter 21: The Economics of Regulation

Governments in much of the world impose regulations on markets. These regulations may take many forms and may have important implications for business managers.

Examples of Government Regulations
1. Antitrust regulations that restrict behavior of large firms
2. Environmental regulations
3. Financial disclosure requirements of publicly traded firms
4. Intellectual property and patent laws
5. Industry specific regulations on banks, transportation and energy firms
6. Federal corporate profit taxes
7. Minimum wage legislation
8. Labor union bargaining requirements

Reasons for Government Intervention in Markets
1. Government Defines and Enforces Property Rights
This is a critical function of government, as few individuals would make investments if they were not sure about their property rights.

The textbook points out that in wartime, famine often erupts because farmers are not secure in their property rights over the crops they plant.

Regulations associated with the enforcement of property rights might include a requirement that the owners of assets (especially real estate) register their ownership with the government so that if there is a dispute, the government has a basis for predictable resolution.
2. Government Attempts to Correct Market Failures

A market failure occurs when the market doesn’t provide an efficient quantity of a good. In these situations, there is the potential for improvements in efficiency if the government imposes some regulation on the market.

a. Externalities

An externality occurs when the actions of one person have an impact on another person and there is no compensation for the impact. The most common example is pollution, when an action taken by one person hurts another person. As a result, the first person does too much of the damaging action because they do not take into account the damage done to the second person.

Government may address an externality either by reducing the amount of the activity or by trying to reduce the damage done per unit of the activity.

For example, burning coal to generate electricity results in a variety of pollutants being released to the atmosphere. The government might try to reduce the amount of this pollution damage either by imposing regulations to lower the amount of electricity that is generated or by requiring that power plants reduce the emissions per unit of power generated.

b. Public Goods

A public good is a good that can be enjoyed by many people simultaneously and that it is difficult to prevent a person from consuming.

Examples of public goods include public health, national defense and a clean environment.

Markets will not provide public goods because there is really no way to make people pay for their provision, so governments much tax people and then provide public goods, either directly or by hiring private firms to provide them.

c. Monopolies

Monopolies generally produce too little of a good and sell it for too high a price. Governments can either prevent the formation of monopolies through bad practices or might choose to create monopolies and then regulate the prices that they charge.
d. Informational Failures
Information is a bit like a public good. Once it is created, it is difficult to restrict access to it and it is difficult to make people pay for it. As a result, markets won’t necessarily create the efficient quantity of information.

Government might address this problem by collecting and distributing information itself (and, perhaps, issuing regulations requiring firms to provide this information) or by forcing that firms behave in such a way as to make some types of information unimportant.

For example, banking regulations require that banks take a variety of actions that make them more secure. As a result, banks in the U.S. are generally so secure that potential depositors almost never concern themselves with gathering information on how secure their bank is.

3. Redistributing Wealth
Some government regulations have the goal of redistributing wealth within a country. Some of this is through programs that put taxes on people with higher incomes and redistribute it to people with lower incomes, but there are other examples.

For example, restrictions on sugar imports into the U.S. transfer wealth from sugar consumers to sugar producers in the U.S.

Restrictions on who may operate taxi cabs in many cities transfer wealth from people who would like to operate taxis and from people who use taxis to people who have the permits to operate taxis and have the permits to do so.

The U.S. government put restrictions on imports of Japanese automobiles in the 1980’s. This was intended to transfer wealth to U.S. automakers, but it also transferred wealth to Japanese automakers and took wealth away from U.S. consumers.

The important thing to remember is that when the government restricts trade with the goal of redistributing wealth, it damages the economy because firms that produce things at the lowest cost might be kept out of the market.
Political Economy of Regulation
Why would government ever choose to implement trade restrictions that would generate net losses for an economy?

The answer is that the people who will gain from these restrictions gain a lot while the people who lose, though there might be millions of them, each lose very little. As a result, the people who gain from trade restrictions fight like hell for them while those who lose don’t fight against them.

This is an example of the free rider problem.

How to Make Government Regulation Work for You
Sometimes government regulations are intended to address problems in markets and make economies work better. Other times they’re just meant to enrich people who donate a lot to political campaigns.

However, given that government regulations (even evil ones) will likely happen anyway, here’s how to use regulations to your advantage.

1. Get the Government to Restrict Entry into Your Industry and Limit Your Competitors

This is totally evil, but if you can establish entry barriers to your industry, you can maintain high profits indefinitely. The easiest way to do this might be to organize with other firms in your industry and get the government to establish some legal barrier to new firms getting in, perhaps through a licensing requirement that the firms currently operating can control.

The arguments for exclusion of new firms should be based on silly ideas such as price stability, safety concerns about new operators in the industry, and preservation of an industry that is a critical part of the national heritage, especially if the potential entrants are foreign.

You shouldn’t tell lawmakers how much this will hurt consumers.
2. Form Coalitions with Groups who Also Want Restrictions

A strong organization of people who want trade restrictions can be very effective, especially if the organization is made up of people who are usually against each other.

The example in the book is that Baptists (members of a religion that is opposed to drinking alcohol) and Bootleggers (people who make their living illegally distributing alcohol) would band together to get laws passed that prohibited the consumption of alcohol.

A second example given is that of environmentalists and people who mine high sulfur coal organizing to require that scrubbers be installed on new coal burning power plants in the U.S.

A strong organization, even if it is small, can be very influential in affecting government regulation.

3. Participation in the Political Process

There’s a bit of an ethical problem here in that getting government to restrict trade in the absence of externalities is evil. It results in net losses to an economy while benefiting a small number of people.

However, as the book points out, a manager does have a responsibility to maximize the value of his or her firm, and if regulations restricting entry and competition can increase the value of the firm, a manager has some responsibility to shareholders to try and get these regulations imposed.