

### 3-7: Regulation

Regulation is direct or indirect involvement of government in the decision making processes of business and individuals.

Commerce clause of the U.S. Constitution establishes the power for the federal government to regulate interstate commerce.

Munn v. Illinois, a state regulation case that was appealed to the Supreme Court, establishes the public interest theory of regulation.

Economics has two schools of thought on regulation:

1. The “Public Interest” view – that regulators manage the regulation process as benevolent arbiters, working for the best interest of society as a whole. This is inherently a normative theory.
2. The “Economic Theory of Regulation” – that views regulatory processes as a complex of bargaining, supply and demand forces, and political influence. This is (or seeks to be) a purely positive theory of regulation.

Most calls for regulation rest upon some argument that a market failure problems exists. The most common form of this argument is the natural monopoly argument. Forcing a natural monopolist to adopt marginal cost pricing, however, is unworkable. Average cost pricing with some “normal” rate of return is the most common form of price regulation.

[See additional handout on regulation.]

Economic Regulation in the U.S. -- Background	
1789	Article 1, Section 8 of the U.S. Constitution establishes the power of the Congress “to regulate commerce ... among the several states.”
1877	In its <i>Munn v. Illinois</i> decision, the Supreme Court upholds the right of states to engage in price regulation: “When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use and must submit to be controlled by the public for the common good to the extent of the interest he has thus created.”
1887	Establishment of the Interstate Commerce Commission (ICC) – the first national regulatory commission in the U.S.
1938	Establishment of the Civil Aeronautics Board (CAB).
1960s/1970s	Establishment of agencies to address worker safety (OSHA, 1970) and environmental concerns (EPA, 1970) epitomize the growth of “social regulation.”

Regulation – Two Schools of Thought	
<b>Public Interest Theory</b>	
<ul style="list-style-type: none"> <li>▪ Regulation is in the “public interest”</li> <li>▪ Essentially a market failure story</li> <li>▪ Focus is on <i>normative</i> analysis of “best” social outcomes</li> <li>▪ “Natural monopoly” or efficiency dilemmas</li> <li>▪ Ramsey pricing and cost of service (COS) regulation</li> <li>▪ Contestable markets and franchise bidding</li> </ul>	

Regulation – Two Schools of Thought	
<b>Economic Theory</b>	
<ul style="list-style-type: none"> <li>▪ Regulation is the outcome of a bargaining process among interested parties</li> <li>▪ Essentially a supply and demand story</li> <li>▪ Focus is on a <i>positive</i> analysis of distributional effects of regulation and interest group influence</li> <li>▪ “Regulatory capture” as a theoretical precursor</li> <li>▪ Cross-subsidization pricing</li> </ul>	

