Düsseldorf Institute
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On the Philosophy of Regulation

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Structure of my talk

- Traditional views on regulation: market failures
- The political economy of regulation
- The new institutional economic view on regulation
- Insights from behavioural economics
- Modern political economy considerations: Political sustainability of regulatory systems.

The (very) traditional view of regulation

Short version: If there are market failures, regulation may be warranted.

Key exercise: Identify market failures, such as:

- Public good characteristics of markets
- Externalities
- Natural monopolies (natural oligopolies?)
- Information asymmetries
- And new: behavioural biases.

The analysis largely focuses on material rules, such as correct prices and quantities and mechanisms to induce them.

By and large, this is still the dominant view in many places: Regulatory fine-tuning.

Further theoretical development: Information asymmetries, mechanism design.

The political economy view I

Chicago School (capture theory) examines the how regulated groups influence regulation

Idea: there is a political/lobbying equilibrium of interest groups (Becker)

Small homogeneous existing groups versus large disperse and heterogeneous groups

Consequence: Regulation tends to be biased in favour of "incumbents".

Virginia School examines motives of regulators and policy makers

Idea: Regulatory systems are characterised by principal-agent-problems, where bureaucrats have expert knowledge and pursue their own interests (starting with William Niskanen)

Consequence: Agencies tend to grow inefficiently large and take on too many tasks.

The political economy view II

The particular role of specific investments (especially in network industries)

Once specific investments have occurred (and costs are sunk), the investing firm is captured/ locked in by the regulatory regime, in particular if investments are location specific

Hence: There is a regulatory hold-up risk that the regulator changes regulations so as to exploit the “investor”

This tendency is stronger (everything else equal) the more consumers (voters) are local and investors international firms

Literature: Sidak/Spulber (1996), Deregulatory Takings

The new institutional economics view

Comparing alternative institutional arrangements:
Market failure versus regulatory/Government failure (Coase, Demsetz, …)

- Note: ***Every*** regulatory system contains two types or errors:
  - Type 1: Regulation occurs even though not efficient/necessary.
  - Type 2: No regulation even though efficient/necessary.

There are trade-offs, e.g. between dynamic and static efficiency.

- Two objectives:
  - Customer protection against producers' market power.
  - Investor protection against expropriation (hold-up) through the Government.

Regulation may be interpreted as an implicit contract between producers and consumers, which is administered by an (impartial) regulatory authority (see Goldberg, 1976).

A comparative institutional approach

Question 1: What material law (rules) should be applied? (e.g., competition law or sector-specific regulation)

Question 2: Who should apply these rules? Which agencies should be responsible? Private enforcement?

Question 3: When should they be applied (ex ante or ex post)?

Question 4: How should enforcement agencies be organised? (e.g., sector-specific versus general purpose agencies? Commissions?

Question 5: Which kind of courts should be responsible? How should they be organised?

Also note: While these questions can be answered separately, there are strong institutional complementarities.

Institutional complementarities

The material content of regulations is often as important as the procedures for their execution and the institutional set-up.

Example 1:
Competition law enforcement of the very same articles (101 and 102) by (a) the German Cartel Office and (b) the European Commission.

Results are rather different, even though the two authorities enforce the same law!

Differences:

- Policy objectives differ (e.g., market integration objective at EU level),
- High degree of independence in Germany, very political enforcement in Brussels (e.g., Google case).
- Institutional culture and tradition differs.
- Internal organization (peer review, role of chief economists) differ.

Institutional complementarities

Example 2:
Private competition law enforcement in European countries and the USA.

- In the US, competition law enforcement through public agencies (DOJ, FTC) varies quite heavily depending on political majorities.
- Private enforcement stabilises enforcement, as it is independent of politics.
- In Germany, competition law enforcement by the authorities is very stable and almost completely independent from the Government of the day.
- Hence, the need for private enforcement is much lower in Germany than in the US in order to achieve deterrence.

Private and public enforcement complement each other. An isolated comparison of either public or private enforcement is by construction misleading.

There can be not isolated “best practice”.

Example 3: Net neutrality provisions and local loop unbundling (LLU) requirements.

Behavioral economics insights for regulatory design I

A lot of recent literature discusses how behavioural biases may give rise to new reasons for regulatory interventions (nudging, libertarian paternalism, …).

There is not a lot of thinking about how behavioural biases affect the optimal design of regulatory (or other) authorities, even though there are people working within these institutions. (Exemption: Cooper/Kovacic, 2012)

Moreover, authorities are not subject to the selection process (Darwinism) of competitive markets, i.e. there is no automatic correction for biases (weak feedback mechanism).

Behavioral economics insights for regulatory design II

Relevant biases:

- Anchoring effect: First impressions matter,
- Status quo bias (and “ownership” of policies),
- Confirmation bias: looking for evidence supporting one’s own view of the world,
- Hindsight bias (especially relevant for regulatory interventions),
- Overconfidence (e.g., w.r.t. remedies, own policy suggestions),
- Omission bias: Doing nothing is not as bad as making errors,
- Hyperbolic discounting: Fast successes are valued more than future costs.
- Representativeness bias.

Stylised example for respresentativeness bias I

Assume that 85% of all markets/cases are characterised by effective competition, while 15% of all markets do not see effective competition.

Also assume that a certain vertical restraints (say, RPM) is used in 80% of all markets that do not have effective competition, while it is only used in 20% of the markets that have effective competition.

Question: Should there be a general presumption that this practice is anti-competitive, given that it is “typical” for markets without competition?

Put differently, should we infer that if this practice is used there is probably a lack of competition in the market?

Stylised example for respresentativeness bias II

Many subjects think so. But the correct answer, found by using Bayes' theorem, is: No, we shouldn't.

There is a 12% overall chance (15% times 80%) of the observation pertaining to a market without competition.

There is a 17% overall chance (85% times 20%) of the observation pertaining to a competitive market.

There is therefore a 29% chance (12% plus 17%) of the practice being observed at all when looking at a given market.

This results in a 41% chance (12% divided by 29%) that the market is not competitive, given that practice is observed. In 59% of all cases the market is competitive, given that the practice is observed.

Hence, a presumption of the practice being anti-competitive is not warranted.

Consequences for regulatory design

Behavioral economics and political economy suggest there may be over-enforcement.

There is too strong a focus on outputs (measurable) rather than outcomes (hard to measure).

Potential Solutions:

- Internal control mechanisms (QA, contestable advice within agencies),
- External control mechanisms (ex post policy evaluations, contestable advice between agencies, monitoring institutions).
- Example: Strong focus on internal control mechanisms by EU DG Comp, strong focus on external control in Germany.

Carefully thinking about the costs and benefits of inquisitorial vis-à-vis adversarial regulatory procedures.

Example: Comparing Competition Law and Regulation

	Competition Law	Telecommunications Law
Objectives	• Consumer Surplus • Efficiency • Freedom to Compete	• Consumer Interest • Undistorted Competition • Universal Service • Efficient Investment • Fostering Innovation
Intervention Threshold	Abuse of dominant position, essential facility doctrine	SMP // 3-criteria-test
Frequency	„Pointwise“ Intervention	Systematic industry coverage
Information	No continuous monitoring, Burden of proof with authority	Continuous monitoring, Burden of proof with firms
Instruments	(Ex post) prohibitions, no positive price setting, other remedies	Ex ante control, positive price determination, other remedies

Example: Comparing Competition Law and Regulation

	Competition Authorities	Regulatory Authorities
Degree of Independence	often high (e.g., Germany)	not quite as high
Lobbying Exposure	not as high	high
Expert Industry Knowledge	not as high	high
„Culture“	Distortion of competition is the exception, as is market intervention	Distortion of competition is the rule, as is market intervention
...		

Example: Comparing Competition Law and Regulation

Weaknesses of competition law and authorities if:

- Abuse of market power leads to irreversible damages (obstructive abuse versus "merely" exploitative abuse),
- Abuse is likely to occur on a recurrent basis,
- Abuse if difficult to detect or to "verify" (information requirements),
- Prices or other terms and conditions have to be positively set in the absence of comparable markets,
- Long-term nature of intervention in dynamic environment.

Strength of competition law and authorities:

- Freedom to compete and to adjust to changing market conditions is less restrained,
- Lower exposure to lobbying groups,
- Typically higher degree of political independence, i.e. lower degree of interference.

Example: Comparing Competition Law and Regulation

Note however: Competition law and its enforcement have further developed over the last few years:

- Higher penalties for abuse of market power,
- Private enforcement,
- National differences (e.g., culture, political independence, …)

Also note: Competition law (and enforcement agencies) differ between jurisdictions.

Regulation is superior if distortions of competition are not singular, non-temporary and if there is a high probability that abuse of market power leads to irreversible damages on a regular basis.

Some notes on political sustainability

We live in reality.

In democracies, policies may not be sustainable if a majority does not participate in the benefits (see, e.g., Acemoglu & Robinson, 2013).

Example: Deregulation of network industries. While universal service obligations may be considered inefficient, they can safeguard the deregulation process.

Put differently, there are distributional constraints that need to be considered.

Also one needs to think about commitment devices and the political reversibility of reforms.

Example: Privatisation as a commitment device for the Government not to tilt the level playing field in favor of its own firms.

Overall conclusions

- It is not sufficient to identify (old and new) market failures in order to justify Government regulation.
- Instead, we need a comparative institutional approach, accounting for (a) regulatory failures (taking the political economy of regulation into account) and (b) behavioral biases also within agencies (with weak feedback mechanisms).
- However, institutions can be designed to remedy some of the behavioral biases to some extent.
- The comparative institutional analysis of regulatory systems should also account for institutional complementarities, something very often ignored.
- Institutions also need to be designed to be politically sustainable.

Thank you for your attention!

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