Maurer School of Law: Indiana University
Digital Repository @ Maurer Law

Indiana Law Journal

Volume 51 | Issue 3

Article 7

Spring 1976

The Search for Limits and the Quest for Theory (Introduction to The Deregulation of Industry Colloquium)

Joseph F. Brodley
Indiana University School of Law

Colloquium: The Deregulation of Industry

Introduction: The Search for Limits and the Quest for Theory

JOSEPH F. BRODLEY*

Uneasiness with the regulation of industry is not new. At varying times from the passage of the Interstate Commerce Act in 1887 onward the wisdom of particular regulatory schemes has been challenged. The cry for radical regulatory reform is thus not voiced for the first time. What is new about the present movement for regulatory change is the broadness of its critique and its willingness to generalize the deficiencies of regulation across industry lines.

The causes of the current loss of public confidence in regulation are several, and no doubt include a diminishing level of confidence in governmental institutions in the post-Watergate era. But there have also been developments within the regulatory field which have influenced the present skepticism. To begin with, a growing number of industry case studies have reached highly critical conclusions about the results of regulation in particular industries,[1] and their impact was not softened by the spectacular failure of the nation's largest railroad in the industry longest regulated.

At the same time the theoretical justification for regulation was also being undermined, or at least challenged. The received justification had been that regulation had arisen in order to promote the public interest where market imperfections, such as natural monopoly and large externalities, precluded the normal reliance on a competitive market to achieve socially beneficial results. This public interest theory was challenged by a radically different, almost sinister, theory of capture or cartel exploitation.[2] According to this theory, regulation, far from being imposed by resolute public officials on presumably reluctant firms, was actively induced by industry as a cover and a vehicle for cartelization.

Alternatively, it was suggested that regulation was in reality a somewhat disguised method of redistributing income, or a form of taxation,

* Professor of Law, Indiana University, Bloomington.

1 *See* W.A. JORDAN, AIRLINE REGULATION IN AMERICA: EFFECTS AND IMPERFECTIONS (1970); PROMOTING COMPETITION IN REGULATED MARKETS *passim* (A. Phillips ed. 1975); MacAvoy, *The Regulation-Induced Shortage of Natural Gas,* 14 J. LAW & ECON. 167 (1971).

2 *See* P. MACAVOY, THE ECONOMIC EFFECTS OF REGULATION (1965); Stigler, *The Theory of Economic Regulations,* 2 BELL J. ECON. & MAN. SCI. 3 (1971).

by which some users of a regulated service subsidized other users.[3] But the legitimacy of such redistribution was not easy to defend, for those who paid the subsidy—the trunk line users—were not necessarily richer than those who received it—the peripheral users.

Growing dissatisfaction with regulation has led to various proposals for deregulation, and several bills have been introduced into the Congress. But these proposals have made notably little progress, and the achievement of any significant deregulation is at this writing highly problematic.

Is part of the barrier obstructing the movement toward any significant deregulation due to the absence of effective criteria for determining when and to what extent deregulation should be pursued? Indeed, can we be so bold as to ask whether a general theory of regulation is possible? After all, whatever the reason for its original enactment, regulation once in place changes the environment in which an industry operates and firms make decisions. But does it then follow that each regulated environment is *sui generis,* or can some generalizations be made across regulatory boundaries that will be useful in determining how far deregulation should be carried and what theory should light its way?

To address themselves to these and similar questions a mixed group of economists and legal scholars were invited to prepare principal papers and comments, to be delivered at the annual meeting of the Association of American Law Schools on December 27, 1975. This colloquium is the fruit of that effort.

In the first paper Professor Liebeler urges that the theory of deregulation be based on the concept of the zero-based budget. Under such an approach each regulatory scheme, and every part of it, would have to justify itself on the assumption that the slate was wiped clean and the regulation was under consideration for adoption. The only justification for moving beyond the point of zero-regulation (or in this context, for not deregulating) would be a demonstrated market failure. Market failure is defined narrowly in terms of unavoidable externality effects, *i.e.,* industry behavior that cannot be internalized into firm decision-making at acceptable transaction costs. Even then, regulation would be permitted only to the extent necessary to correct the specific market failure and restore the possibility of market transactions. Applying this approach to drug regulation, where the market failure (if any) is a lack of adequate information on the long term efficacy of new drugs, the ap-

[3] *See* Posner, *Taxation by Regulation,* 2 BELL J. ECON. & MAN. SCI. 22 (1971).

propriate regulatory correction turns out to be simply the providing of sufficient information to the public to permit individual consumer choice. Finally, any special problems of deregulation caused by the presence of an existing regulatory system, such as interference with vested property rights or inequitable income redistribution, should either be ignored as unavoidable frictions or compensated by direct subsidy.

Professor Noll finds the course of regulation beset with institutional problems, including bias and delay, an excessive clinging to the status quo, a decisional system frequently requiring administrative choice to be made on insufficient data, and a philosopher-king complex compelling the appearance of administrative infallibility. Like Professor Liebeler, he prefers a decentralized market decision where possible. He recognizes, however, that complete deregulation is not feasible where essential features of a decentralized market are lacking, including (1) numerous participants, (2) cheap and reliable information, and (3) property rights. Accepting the need for regulation under these conditions, he calls for the use of greater imagination in devising (or revising) the regulatory tools. More specifically, he would first ask whether there is a specific market failure that can be identified and bridged (here his approach is similar to Professor Liebeler's). But second he recognizes that some market failures cannot be bridged and that in those instances centralized regulation will remain necessary (*e.g.*, hazardous complex machines). However, bearing in mind the institutional weaknesses in the regulatory process, improved results can be obtained by sharply separating the fact-finding and evaluation process of regulation from the ultimate decision-making responsibility. While the former would remain in the hands of the administrative agency, the latter should be recognized for what it is—a political decision—and placed in the hands of an institution more capable of making that kind of choice, namely the Congress.

For Professor Wilson a scientifically rigorous theory of deregulation is as incapable of present realization as is a general theory of regulation; both would require inclusion of an unmeasurable variable—political power. The more useful question to which we should address ourselves is under what conditions deregulation is most likely to be successful. Such an approach enables the formulation of specific guidelines for deregulation, which Professor Wilson enumerates: (1) identification and quantification of the costs of existing regulation, (2) assessment of the benefits of such regulation, (3) ascertainment whether the benefits are attainable by less costly means, and (4) implementation of deregulation gradually in a step by step extension of the bounds of discretionary behavior. Applying these guidelines to his own area of specialty, the Interstate Commerce Commission, Professor Wilson finds the costs of regulation to be high in lost efficiencies and the benefits to be largely in the form of transfer payments by which one class of customer subsidizes another. He determines that if these benefits are desired, they can be better achieved by direct subsidy payments. Nevertheless, deregulation would impose adjustment costs and forfeit or diminish some existing property rights. Thus, the gradual approach to deregulation incorporated in several congressional proposals, allowing rate changes within a defined range and easing entry and exit restrictions, commends itself. The basic thrust of deregulation policy in transport (and perhaps elsewhere) would be to give much greater weight to considerations of efficiency and technology advance, and to meet other social goals by direct policies.

Professor Schwartz also rejects the need for a theory of deregulation, but for different reasons. Acknowledging that there are serious problems with current regulation, he argues that the failure is not one of theory, but rather of the performance of the regulators. Focusing on the field of electric power regulation, he finds that rate regulation has been defective because it has been administered essentially on a cost-plus basis, insulating the regulated firms from risk and providing inadequate incentive for optimal behavior. In addition, the regulatory agency (FPC) has consistently failed to promote competition, both by failing to permit its introduction where feasible and by directly approving anticompetitive arrangements. The proper course of regulatory reform then is to correct these institutional failures, and this can be done by taking two primary steps. First, the existing cost-plus method of price regulation should be replaced and management performance indicators should be adopted by which the efficiency of firm behavior could be assessed; this would then permit administrative recognition of both superior and deficient performance. Second, the regulatory agencies should cease and desist from any toleration or encouragement of non-competitive conduct, and instead should promote competition wherever possible, and much more fully than they have done as a positive force to improve performance, enhance efficiency, and spark technological advance.