

CHAPTER 11

Government Regulation, Laws, and the Market Price

(draft)

Government Regulation

In this chapter, regulation will be defined as a process consisting of the intentional restriction of a subject's choice of activity, by an entity not directly party to or involved in that activity. In stating this, there are a number of points that need to be made. First, regulation is a process, that is it is an ongoing, continuous activity. Therefore if we are going to talk about regulation of a particular market, the enterprises in the market must continually come to the market to sell their goods and enterprises/individuals must continually come to the market and buy the goods. Hence we must not only view the regulated enterprises as going concerns, but the economy itself must be seen as evolving through time. Secondly, regulation is an intentional restriction of a subject's choice of activity. There are three aspects to this. First there are regulatory goals such as stabilizing the market, preventing destructive competition, the continuation of the enterprises involved, etc; second, these goals are achieved by constraining the activities of the enterprises in the market and/or the enterprises that would like to enter the market - in fact, if the regulatory commission deals with competing markets/enterprises, constraints might be placed on enterprises in both markets in order to achieve the desired goals; and lastly, the restraining activities can change/evolve over time to meet new conditions while the

goals remain constant. Thirdly, since regulation is a process through time, the goals it adopted at one point in time might be changed at a future point in time. As a result the constraining activities might also change to accommodate the new goals. Finally, the party directing the activity can be private (cartels for example) or public; and the public party can be a county national government agency or commission. In this chapter we shall primarily be concerned with government commissions and 'agencies' (such as Parliament and the Courts' involvement in resale price maintenance).

There a number of explanations for the origin of government regulation of industry, but we will be concerned with only the private interest explanations. Before discussing the private interest explanations, let us first briefly discuss the public interest explanations. Public interest theories of regulation assume that regulation is established largely in response to public-interest-related objectives. Unless one assumes that the state or public mystically acts for itself in seeking the regulation, public interest theories require, in effect, that parties seeking regulation be agents for the public interest. These agents may satisfy their self-interest instrumentally through pursuit of public interest objectives, but the theory requires that at least some preferences for the public interest be genuine and terminal. The form which public interest takes in these theories are as follows:

- (a) balancing concept in which the public interest results from the simultaneous satisfaction of selected aspects of several

different particularistic interests. The balancing result gives satisfaction to interests that may to some extent be contending or competing.

- (b) compromising concept in which particularistic interests are made to concede part of what they desire so that the overall result is in the public interest.
- (c) trade-off concept in which particularistic interests affected by regulation are made to provide some costly service or other benefit judged to be in the public interest in exchange for certain private benefits to them.
- (d) an overriding national or social goals concept in which certain social, societal, or national objectives are held to be in the public interest and supersede private interests.
- (e) particularistic, paternalistic, or personal dictated concept, unitary in character, in which the public interest is equated with the preferences of a particular person, group or organization, or system.

There are many different public interest theories of the origin of regulation but they will not be discussed here. Rather what needs to be noted is the general argument that lies behind them. The argument is based on two assumptions, that the economy (market) is very fragile and therefore can easily operate in a manner which is not in the public interest, and that regulation is costless and does not make matters worse. With these assumptions, it is easy to argue that regulation is simply a response of government to public demands to correct the problems in the market and that the government can in fact make conditions

better. However there are many problems with this argument - some lying the assumptions and others with the notion of responding to public interest; but the principle problem which we shall be concerned with is that in many cases industries asked to be regulated rather than have regulation imposed on them.

Private interest explanations of the origin of regulation are based on the assumption that enterprises in a market actively seek government regulation in order to achieve a goal or a range of goals particular to them. In general it is argued that the primary goal sought by the enterprises is the maximization of profits and the method sought to achieve it is the use of government regulation to control entry, to affect competing commodities and services, to fix prices, and to grant subsidies.

The first three methods are desired because of the 'free rider' problem. That is, enterprises request regulation because there is no legal way to make all the enterprises in the market conform to a common goal such as setting the same market price. Rather, because of the lack of legal control, enterprises are able to engage in one-up-manship and thus plunge the market into chaos. Therefore legal assistance is sought to prevent this and thus, at the same time, maximize (long or short term) profits.

The problem with the above explanations is that they attribute the origins of government regulation to greed - that is to the desire of enterprises to simply maximize profits. However, the notion of profit maximization cannot be sustained theoretically in a sequential production framework. Rather, the enterprise is interested in growing (expanding) and therefore

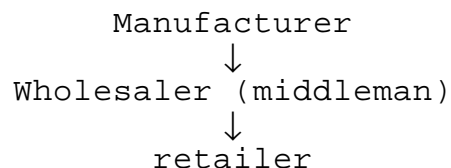
will engage in activities which will promote it. Hence it will request government regulation if it believes that is the only way to maintain itself as a going concern. Specifically, it will be argued in this course that enterprises request government regulation in order to eliminate destructive price competition or the potential for it (by either fixing prices, controlling entry, or affecting competing commodities) so as to maintain themselves as going concerns.

Given the above discussion, it is obvious that the notion of regulatory capture has little meaning in its most common sense since the regulations (or regulatory commissions or agencies) were designed with the enterprises in mind in the first place. However, the term does have some meaning when it refers to the dominant role the enterprises play in the continuing regulation of the market. In this latter case the enterprises ensure that the regulations (or commissions) fully reflect their views as the market conditions change over time.

Laws and the Market Price: The Politics of Distribution

Problems of Distribution in a Historical Context

Let us first look at distribution in terms of its organization. In a simplistic sense the organization of distribution can be pictured in the following manner:



That is the retailer orders its goods from the wholesaler who in turn orders from the manufacturer. At each stage of the process

an independent business enterprise is involved. Therefore this process is costly since the activities of the wholesaler have to be paid for. However, it is necessary if the retailed outlets are very many, small dispersed, and have to carry many thousands of goods. For example, if the retailer is small, then it will not be able to get any quantity discounts if it ordered its goods from the manufacturer; but because the wholesaler can order in bulk it can usually get the quantity discounts which it then passes along to the retailers in form of lower wholesale prices.

Another example is that a small retailer has to order many different kinds of goods and instead of ordering directly from the manufacturers, which would be quite costly and time consuming, it can send a single order to a wholesaler. This 'traditional' mode of distribution has been altered to include a direct relationship between the manufacturer and retailer where the retailer can consist of a hugh department store, a mail-order house, or a chain store. In the former cases, the retailer consists of a single entity, whereas a chain store consists of many separate selling units. This process of distribution is generally less costly than the traditional process because many of the wholesaler costs have been eliminated, the retailer has a more efficient method of distribution, and the retailer can use its economic power to extract larger discounts from the manufacturer. It should be obvious that when the traditional and non-traditional distributional processes exist side by side in the market, problems will emerge at the retail (and wholesale) level in that the small independent retailer is being replaced by

the mass distributor. It is this conflict which we shall be concerned with in this section. To do so, however, requires that first a historical discussion of the changes in the distribution processes and the emergence of the mass distributors needs to be undertaken.

Problems of Inter-type Competition and Vertical Competition

Inter-type competition - it is the competition between different methods of distribution.

- (a) the economic bases of conflict permit and encourage grouping of the sort required for effective political actions;
- (b) we find similar stores, sharing common methods of operation, objectives, and standards of business ethics and they face a common enemy.
- (c) explore this type of competition in distribution of groceries and drugs.

Distribution of groceries

- (a) chain store vs. independent

Distribution of Drugs

- (a) chains (price cutters) vs. retail druggist

Resale Price Maintenance

Laws and Market Control

Concerned with the proposition that business enterprises engage in political activity and urge laws to be passed (esp. laws of regulation) which can be used as a competitive to give them an advantage in the market place. Let us consider the example of the 1906 U.S. Pure Food Act (Food & Drug Act). Some

of the interests in the Act stemmed from the following:

- (a) fraud, nutrition and worker efficiency
- (b) foreign commerce - because of absence of such law, U.S. products were banned in European countries; and on the other hand, Europeans were able to dump products in U.S. to de-stabilize U.S. markets.
- (c) inter-state commerce
 - (i) States have different laws so fragment national market.
 - (ii) a national law would provide a set of shared rules for food and drug industries, leaving them free to compete in national markets on the basis of price, quality and regional product distinctions.
 - (iii) 2nd problem generated by the growth of inter-state commerce was that reputable manufacturers in a State had no protection from the competition offered by adulterated or mis-branded goods produced out of state.
 - (iv) so national law offers protection.

Trade Wars - occurred when traditional/pre-existing industries competing for the same portion of the consumer market (product substitution) - example butter vs. oleomargarine under act oleo is seen as a counterfeit article. Within industries - manufacturers of traditional well-accepted products sought to continue to dominate a market threatened by newer and much cheaper product formulas.

- (a) baking powder war - the great baking powder war erupted when

the older cream of tartar powders began to lose market share to the effective and much less expensive powders that used other acids. Cream of tartar manufacturers responded with campaign to have alum powders legally declared poisonous or, failing that, to convince consumers that they were poisonous. So, as a result the 1906 Act contained a passage which defined food adulteration as "any added poisonous or other added deleterious ingredient which may render such article injurious to health" aimed at Alum users - alum powder manufacturers went to regulatory agency for decision and eventually won out.

- (b) whisky wars - Distillers of bottled-in-bond liquors favored a pure food law that would declare competing products - rectified whiskies -to be adulterated. Rectified whiskies were solutions of grain alcohol, water, sugar, flavoring and coloring. They were not aged and were easily and cheaply manufactured. Bonded distillers saw little hope of having the rectified products banned outright, but they saw considerable advantage to themselves in having such goods labelled artificial whisky - since that would destroy their competitors.
- (c) drug wars - manufacturers of ethical drugs (medicines who advertise only to physicians) lined up against the makers of proprietary remedies (itinerant medicine men). The former favoured a law that would drive the patent medicine interests out of business.

Terms

regulation
public interest
private interest
regulatory capture
inter-type competition
vertical competition

Exercises and Questions

1. What is regulation and why is usually associated with government regulation?
2. What are some of the private interest explanations of government regulation?
3. What are some of the public interest explanations of government regulation?
4. Why is it hard to define the public interest?
5. What are the differences (if any) between private and public interest explanations of government regulation?
6. Are there any real differences between the outcomes of government regulation in the name of private interests vs. government regulation in the name of the public interest?
7. What is regulatory capture? Does it really exist?
8. In what ways are laws a form of government regulation of market activity?
9. The regulation of market activity by laws and other means of government is a competitive strategy often adopted by business enterprises. Explain.

Readings

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