Regulation, Fairness, and Efficiency

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Objectives of Natural Monopoly Regulation

Efficiency, efficiency, efficiency:

1. Allocative Efficiency
2. Productive Efficiency
3. Dynamic Efficiency

Other objectives? - maybe

Is efficiency really pursued?

Viscusi, Vernon, and Harrington (2000, p.44):

"In theory, regulatory agencies serve to maximize the national interest subject to their legislative mandates (…) Such a characterization of regulatory objectives is, unfortunately, excessively naïve. There are a number of diverse factors that influence policy decisions, many of which have very little to do with these formal statements of purpose."

Q1: Why don't we observe Ramsey pricing to allocate common costs in real life?

A: Information? Think about incidence of these mark-ups.

Is efficiency really pursued?

Q2: Why are we concerned about the X in CPI-X-regulation?

To enhance allocative efficiency? In electricity consumption?

Bundesnetzagentur (2006, p. 13):

> "To increase efficiency cannot be the only objective pursued by incentive regulation. The aim of Government intervention must also to limit the profits from natural monopoly."

Q3: Why are universal service obligations and uniform pricing requirements so common?

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Examples: Electricity

Are policy makers concerned about the efficiency of electricity markets?

- Allocative efficiency? – hardly.
- Dynamic efficiency? – maybe.
- Productive efficiency? – somewhat.

Q: Are policy makers concerned about distribution/fairness?

A: Yes, definitely. Distribution issues between local Government, central Government, firms and consumers.

And: Price cuts tend to increase consumption (in the long-run).

Examples: Telecommunications and Rail

Telecommunications – current issues:

- Digital divide, rural broadband, universal service
- How to foster innovation and new services
- Side step: dynamic vs. allocative efficiency trade-off also has distributional consequences (at or above marginal cost pricing)

Rail:

- Transport in rural areas.

Effects of Focusing on Fairness

(Shift of) Focus on Consumer Surplus in European Competition Policy:

- Neven and Röller (2005): Lobbying Incentives are systematically different for consumers and merging firms → consumer standard better suited to reach efficiency (total welfare)
- Lagerlöf and Heidhues (2005): Information asymmetries between consumers and merging firms → consumer standard better suited to reach efficiency (total welfare)
- Idea similar to Fershtman and Judd (1987): Strategically manipulate agent's (here: the competition agency's) incentives (objectives) in order to achieve final objective (here: total welfare).

Political Sustainability

Societal Legitimacy of Political Reforms is Important:

- Henisz, Holburn and Zelner (2005): Empirical Study of Electricity Supply Reforms/Liberalization in 83 Countries.
- Study analyses factors that determine whether the regulatory framework is changed following an liberalization process or whether liberalization processes are later even (partially) reversed.
- This depends on: (1) the new regime's performance, (2) policy in similar or related countries, (3) vintage of initial reforms and institutions, (4) whether lenders are more multilateral or more national, (5) investors' experience with host country

Political Sustainability

Bundesnetzagentur (2006):

"An increase in efficiency and the associated possibility for firms to keep the realized savings as profit cannot be the only objective of incentive regulation. It must be the objective of Government intervention to limit profits from natural monopoly and pass it on to consumers. Apart from economic aspects, the question of political legitimacy is important. If a regulatory regime is disapproved by the public or if it produces unwanted results, it cannot survive in the long term."

- Hence: "Fair prices" are needed to make a regulatory framework politically sustainable.
- But: A sustainable framework is also important for dynamic efficiency, especially in infrastructure based industries.

Political Sustainability

Alternative efficiency criteria:

- Oliver Williamson (1996): Remediableness – a give situation is only inefficient from a transaction cost perspective if an alternative framework can be implemented that leads to less inefficient results
- Avinash Dixit (1996): Transaction Cost Politics

Models:

- "Political sustainability" must be taken into account as another constraint, e.g. $\underline{CS/\pi > t}$ (or π < t) Similarly, distribution of consumer surplus among consumer groups should be important.

Note: Do firms (voluntarily) redistribute to stabilize the regulatory framework?

Summary

- To safeguard institutional reforms (market liberalization) we have to think about political sustainability (distributional consequences).
- Some redistribution may be efficiency enhancing in a second-best world, especially in infrastructure-based industries with long-lasting investment.
- Dynamic efficiency is, on the one hand, even further distorted to make regulatory frameworks sustainable (fewer consumers benefit from innovation than form price cuts), but sustainability in itself fosters dynamic efficiency.
- Distributional consequences are also important for other, related areas, such as the debate about the allocation of CO2 certificates.
- This may be a promising research area for both theory and empirical work.

Thank you for your attention!

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