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# Clarifying the Record

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## Discussion/*Diskussion*

# Clarifying the Record: A Comment

by

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In their recent article in this journal, BOUDREAUX and EKELUND [1987] have presented a distorted characterization of some of my work on the economics of regulation. The editor of this journal has graciously offered me the opportunity to respond to their criticisms and to redress some ambiguities, real or imagined, in my earlier work.

Boudreaux and Ekelund get off to a bad start by posing a false dichotomy. Is the entire regulatory process, they ask, to be explained in terms of an efficiency-increasing response to market failures *or* as an efficiency-reducing result of rent-seeking activities by politician regulators? I am supposed to subscribe to the former position; they stake out the latter. They then go on to characterize the debate as one between "those in favor of [apparently, me], and those opposed to [apparently, them] government regulation" (BOUDREAUX and EKELUND [1987, p. 538]).

My first objection is that the two varieties of explanation are not mutually exclusive. One could argue that electricity is better provided by a regulated utility than by an unregulated market and at the same time acknowledge that the politicians, regulators, and regulatees will all attempt to use the political system to their advantage. Their argument is akin to asserting that publication of a scholarly research article can be explained either by the author's interest in disseminating its contents or alternatively as an attempt to enhance his future income given the compensation schemes adopted by modern universities. That content matters does not mean that financial rewards are entirely irrelevant. And vice versa.

My second objection is that I didn't say it. In fact, I provided what seemed like a pretty clear disclaimer: "It is important to reiterate that we are not making a case for regulation. This essay might more appropriately be looked upon as 'the case against the case against regulation.'"(GOLDBERG [1976, p. 444]). I intended neither to justify regulation nor to predict its natural emergence.[1] My intent was to explore the types of problems that would confront

[1] "The contemporary idea that government regulation may evolve naturally and optimally as a low-cost response to market failure is perhaps best expressed in the challenging work of Goldberg, although we do not attribute all elements of our simple characterization to him" (BOUDREAUX and EKELUND [1987, p. 540]).

either a regulator or parties to a private contract and their implications for the organization of economic behavior. In this sense, the exercise is in the spirit of COASE'S [1960, p. 18] discussion of institutional choice in a world in which transaction costs are not zero:

"...[T]he problem is one of choosing the appropriate social arrangement for dealing with harmful effects. All solutions have costs and there is no reason to suppose that government regulation is called for simply because the problem is not well handled by the market or the firm. Satisfactory views on policy can only come from a patient study of how, in practice, the market, firms and governments handle the problem of harmful effects. ... It is my belief that economists, and policymakers generally, have tended to overestimate the advantages which come from governmental regulation. But this belief, even if justified, does not do more than suggest that government regulation should be curtailed. It does not tell us where the boundary line should be drawn. This, it seems to me, has to come from a detailed investigation of the actual results of handling the problem in different ways."

While Coase's paper has sometimes been misinterpreted as an argument for relying upon private markets, it is clear that he draws no such implications. The question as to why he (and I) have been misinterpreted is a perplexing one on which I can shed little light.

I was particularly taken aback by the criticism that we new institutionalists "discount heavily the prospect that regulation engenders rent-seeking activity" (BOUDREAUX and EKELUND [1987, p. 539]). I did not discount it. I explicitly assumed the problem away in order to focus on a different set of issues:

"...We shall assume throughout that the agent is a faithful representative of his principal's interests. While a wildly unrealistic assumption, the benevolent agent, like the benevolent dictator of traditional welfare economics, is a convenient analytical construct. This assumption does, however, preclude discussion of the politics of regulation – particularly the charge that regulators are susceptible to political influence by producer interests." (GOLDBERG [1976, p. 430]).

BOUDREAUX and EKELUND [1987, pp. 545–552] invoke SCHUMPETER [1942] in their criticism of the new institutionalism. That really hurts. The whole notion of "protecting the right to serve" was developed in a Schumpeterian framework, complete with quotation and effusive praise (GOLDBERG [1976, p. 435]). That was one flank I thought particularly safe. Schumpeter emphasized that various restrictions which appeared inefficient in a static context need not be inefficient in a dynamic context. There is nothing in Schumpeter's argument – either theoretical or empirical – which would lead one to conclude that only "private" restrictions could possibly be efficient in Schumpeter's eyes. Yet that is the interpretation BOUDREAUX and EKELUND [1987, pp. 545–546] propose.

Perhaps the central message of the new institutionalists (in which group I would classify Coase) is the richness of institutional alternatives. A corollary is

that the distinction between public and private can be unclear. Is government enforcement of a patent system a private or public arrangement? Must Schumpeter be interpreted as saying that a world in which ideas are protected by trade secrets and inventions are contracted for, is a world that is inevitably superior to one in which the government provides patents? I choose this example deliberately since, as I noted in GOLDBERG [1976, p. 435], patent protection is analytically the same as protection of a right to serve a market. The "same" government that hands out patents hands out utility franchises. How can one conclude on a priori grounds that they will do it better in the one context than the other? (To avoid further misinterpretation, I will answer this rhetorical question: one cannot.)

BOUDREAUX and EKELUND [1987, pp. 546–550] argue that Schumpeterian competition will eventually lead to the establishment of efficient contract terms. They switch gears abruptly, moving from the context of a public utility franchise to the relatively mundane problem of determining the optimal warranty length on a consumer contract. Here their paper gets very strange indeed. They begin: "Goldberg, in fact, uses the airline industry to show how consumers could fare better under regulation than under private contracting" (BOUDREAUX and EKELUND [1987, p. 547]). Since I did not recall having become involved in the airline deregulation debate, I found this rather puzzling and returned to the source with some curiosity to see what I had written on the problem. Here it is:

> "... [W]hile the institutions of regulation can be manipulated in the producer's interest, so too can those of private contract. Indeed, the firms might have been better off (and the consumers worse off) under private contract. An unregulated airline industry, for example, might attain a rule stating that the development of a new route is the production of new knowledge and the developer should be granted an exclusive right to the route for some period of time (analogous to patent or copyright protection)." (GOLDBERG [1974, p. 473]).

It is possible, I suppose, to interpret that statement as being consistent with their characterization. But it is, at best, unhelpful. Surely, they should have no difficulty accepting the proposition that firms *might be* better off if, instead of the government regulating airlines, it distributed exclusive rights to routes.

They take issue with my argument as to why optimal warranty terms might not emerge in a competitive market (GOLDBERG [1974, pp. 485–491]). My argument was an application of the lemon's model developed by AKERLOF [1970]. My discussion was sufficiently qualified so that I only suggested that it was possible that intervention by legislatures or the courts might result in better subsidiary contract terms (like the warranty) than would private contract. Nonetheless, the tone of my argument suggested (and that coincided with my beliefs at the time) that the intervention would be a good thing. I am much less sanguine about that today. The roots of this change are both a decreased faith

in the ability of courts and legislatures to do the job well and an increased faith in the ability of private parties to cope with, if not fully resolve, the problems. Courts and legislatures have learned how to justify intervention. But they have not seemed to learn how to intervene. They have not come to appreciate the subtleties in designing efficient contract terms. Moreover, there is some evidence that markets have resolved some of the problems tolerably well; see PRIEST [1981].

So, I can plead at least a little bit guilty to one of their charges. But, for the remainder, save for one rather limp disclaimer,[2] they have badly misrepresented my views. And to what end? They convert the entire Coasian agenda of understanding how alternative institutions work in an imperfect world to a simple ideological question: is regulation good or bad? Having done that, they then conclude that it is bad. While I am not averse to making policy judgments, I will reiterate that I did not take a position on that question.

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[2] See the last clause in footnote 1.