Understanding Regulation

ESNIE

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- We live in a highly regulated society

- We are better off (safer) thanks to regulation

- But it is hard to explain the need for regulation

- This is a challenge for economics

Why the difficulty of explaining regulation?

- Most important result of Law and Economics is the Coase Theorem (1960)

- Leaves room for liability for damages but not for regulation

- Standard economic theory of regulation is capture (Stigler 1971). It focuses on harm from regulation, not benefits.

- Plus competition, reputations suggest regulation is unnecessary

Today's lecture

- Coase Theorem and Its Consequences

- The Normative Case for Regulation of Harms

- Regulation across countries

"The Problem of Social Cost": Why It's a Classic

- Helped launch modern Law and Economics
- Coase Theorem
- Transactions costs
- Bilateral view of externalities
- Skeptical view of government intervention
  - Critique of Pigou

Example

- Andrei likes having wild, noisy parties
- Eric, his only neighbor, likes peace and quiet
- Consider 2 legal rules:
  - Eric has a right to peace and quiet
  - Andrei has a right to party

Coase Predictions

	Eric has right	Andrei has right
Andrei's value higher	Andrei buys permission from Eric	Andrei just parties
Eric's value higher	Eric enjoys quiet	Eric pays Andrei to abstain

Coase Theorem: Assumptions

- Law
  - Clearly defined entitlements ("property" law)
    - *Perfectly and costlessly enforced*

  - Any contract enforceable, including one that defies initial entitlements ("contract" law)
    - *Perfectly and costlessly enforced*

Assumptions (continued)

- Parties (2 or more)
  - All present (at the "bargaining table")

  - Complete, symmetric information
    - Includes knowledge of law
    - Includes knowledge of own and each others' costs, benefits, … (common knowledge)

  - Neoclassical maximizers

Assumptions (continued)

- Bargaining assumed perfect
  - a.k.a. "no transaction costs"

  - And no impediments to reaching some agreement on the contract curve (implies that result is in core of economy)
    - No free-rider, hold-up problems
    - No difficulty identifying & reaching other parties

Coase Theorem

- *If there are no transaction costs, then the outcome (after bargaining) will be <u>efficient</u> without regard to the legal rule.*

- **Proof**: a tautology from the assumption (definition) of "no transaction costs," taken to include that efficient bargains will be made

Relationship to Externality Concept

- What is an externality?
  - Conventional answer stresses lack of a market, so the external effect is not "priced"
  - Hence the private/social cost or benefit divergence
  - Hence the prescription for government action to internalize the externality

- Coase's point, in essence: already *is* a market
  - Those lacking rights they want can buy them
  - Idea of two-way causality

Failure of Coase Theorem: Transaction Costs

- Pure costs of meeting/transacting
  - Actually quite important for myriad small-scale, one-shot activities
- Free riders and holdouts – large numbers problems
  - Ordinary nuisance vs. industrial pollution
  - Auto accidents
- Asymmetric information impedes bargaining (Myerson & Satterthwaite JET 1983)

Transaction Costs: Implications

- Positive: assignment may matter (for reasons beyond wealth effects)

- Normative: "assign right to where would end up *if* there were no transaction costs"

- Normative: no room for regulation

What if transaction costs are high?

- Andrei and Eric cannot (do not) bargain

- Create a liability rule
  - Eric entitled to peace and quiet
  - Andrei liable for damages to Eric

- If Eric's value higher, Andrei will not have a party

- If Andrei's value higher, Andrei will have a party and pay damages

- Liability rules greatly expand the scope for efficient outcomes

- Car accidents, pollution

- Go even further with class-action suits

- Enforcement still crucial

- But no room for regulation

So what are the arguments for regulation?

- Do not focus on capture and politics

- Always compare to litigation / liability

- Present four arguments

Regulation (1): Bankruptcy / "Judgment-proof" problem

- Defendant might be unable to pay

- e.g., small store with bad meat

- e.g., major catastrophe

- Need to stop a problem before it occurs

- But: how universal? Also, injunctions

Regulation (2): Transaction Costs of Enforcement

- Litigation very expensive, esp. if negligence

- Cases too heterogeneous

- If problem widespread enough, cheaper to regulate

- Might be true even if regulation is coarse
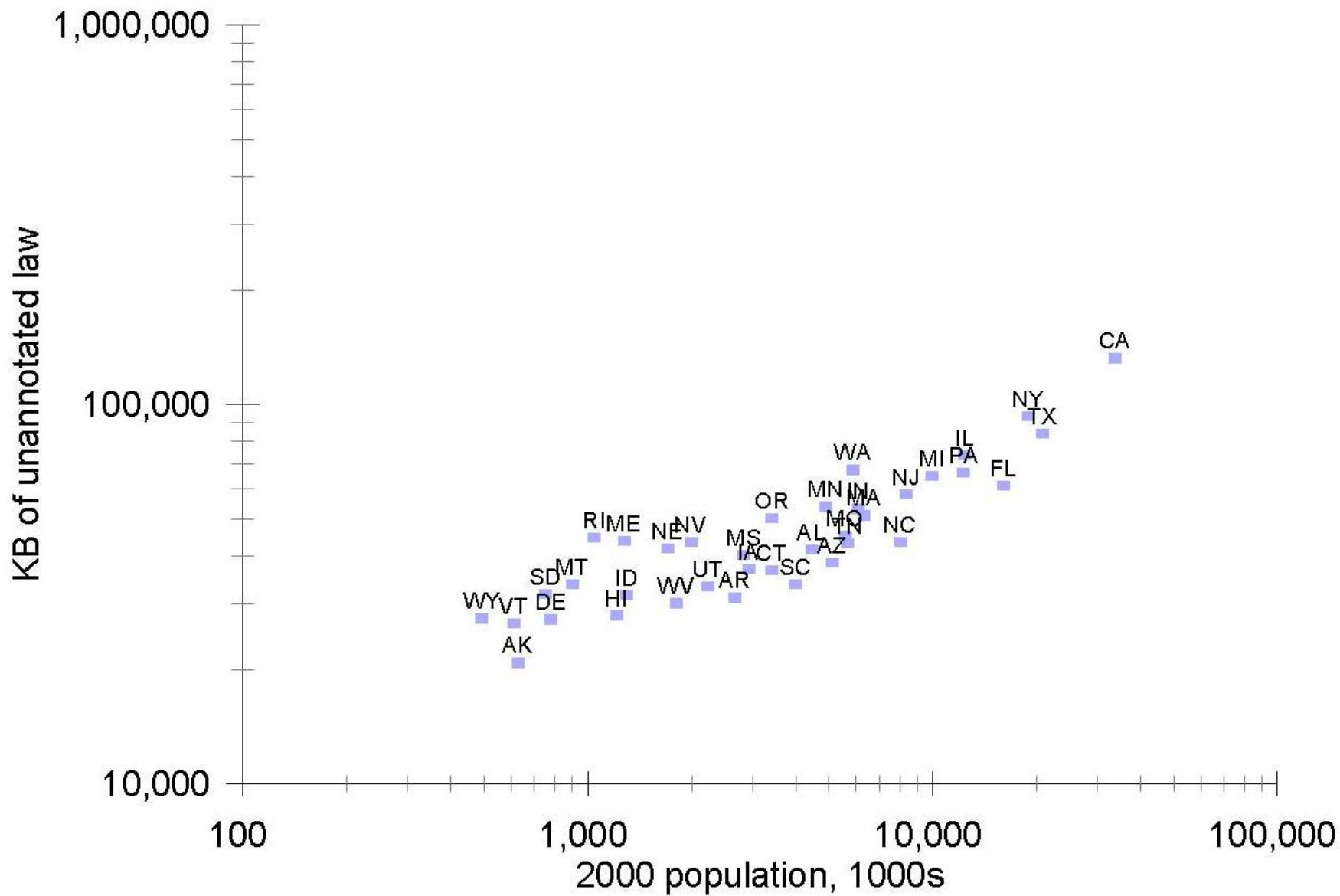
Statutes and Population Across States

Regulation (3): Incentives / Corruptibility of Enforcers

- Judges might be less expert than regulators

- Judges might be lazier than regulators

- Judges might be cheaper to influence / bribe

This is the progressive case for regulation.

But: judges also impartial, fair, less political

Regulation (4): Activity levels

- Fines affect activity levels not just precautions
- Activity levels might be too low
  - e.g., too few parties
- Litigation may discourage activity because of large fines
  - e.g., medical malpractice, drugs
- Regulation will then be preferred

- Normative arguments only part of the story

- Might explain social control across activities

- Big variation is across countries

- Must be understood, reconciled with theory
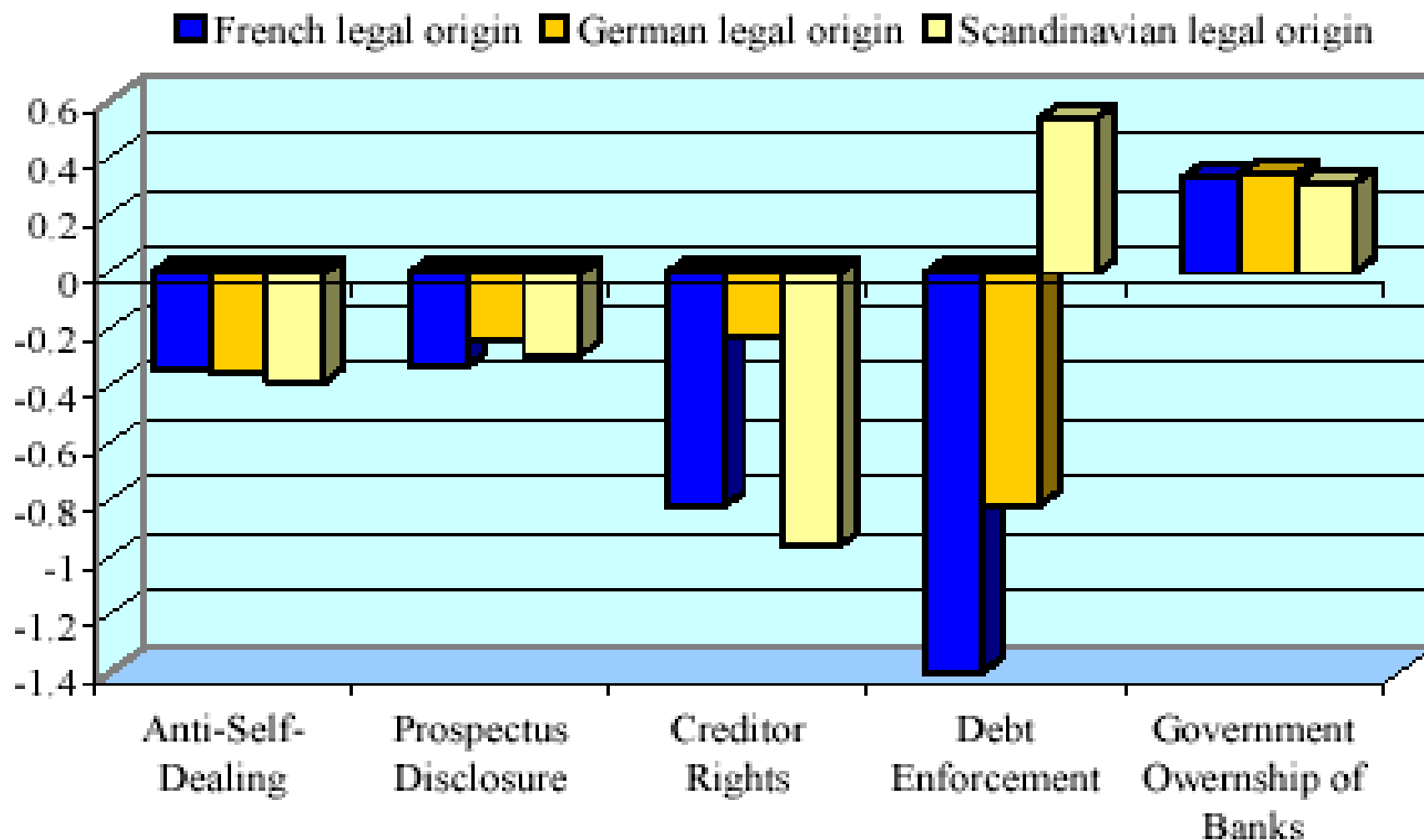
Legal Origins and Regulation

- Countries belong to relatively few legal traditions
  - Common law
  - French civil law
  - German civil law
  - Scandinavian law
- These traditions strong predictors of laws, regulations, other aspects of social control

Legal Origin Distribution

Legend: Legal Origins
- = English (light green)
- = French (orange)
- = German (light purple)
- = Scandinavian (teal)
- = Socialist (red)

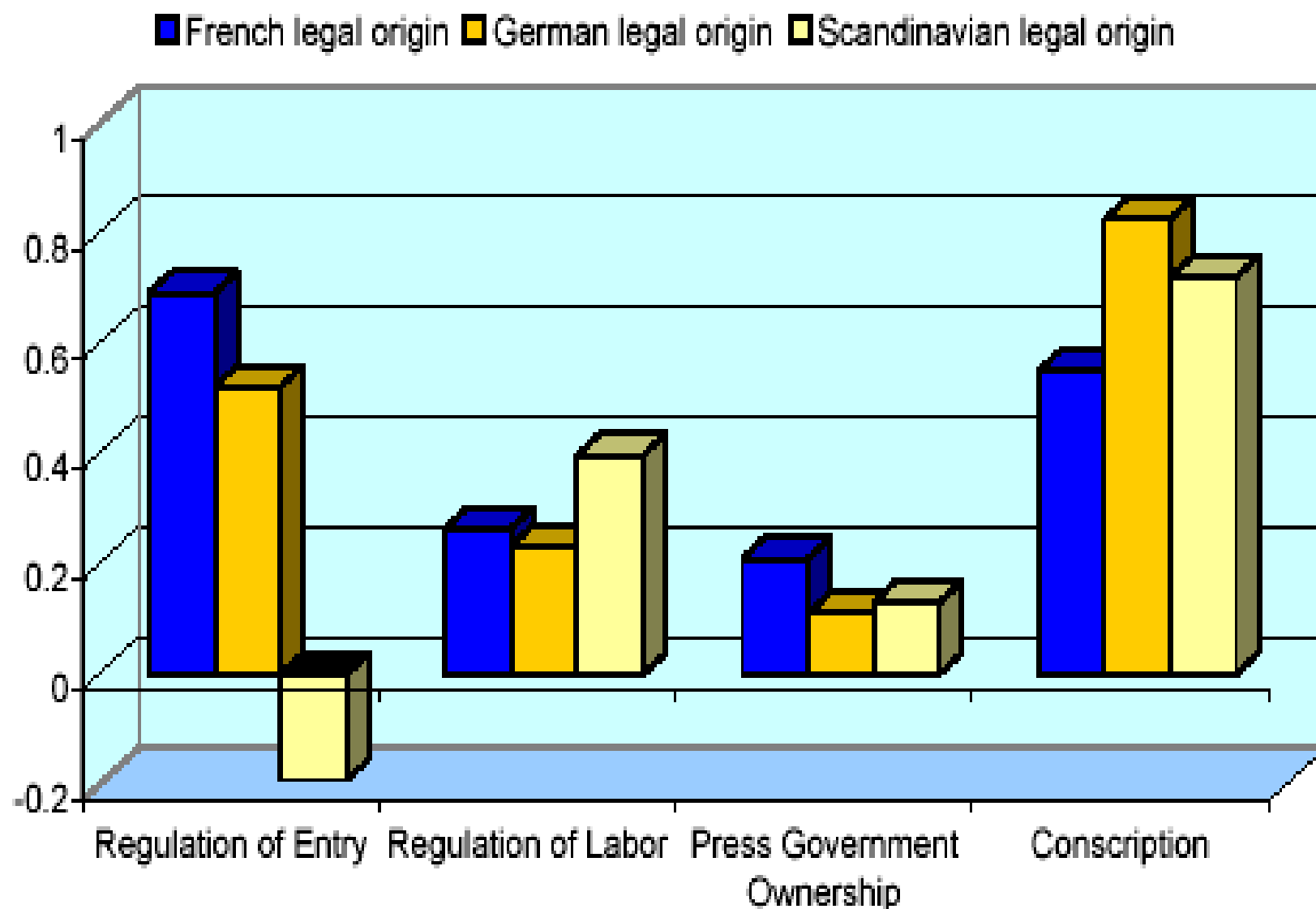# Financial Institutions and Legal Origins

The values represent the average difference of the countries within each legal origin relative to the countries of the common law legal family. The values are the coefficient of each legal origin dummy in a regression that also controls for the Log of GDP per capita and a constant.

■ French legal origin ■ German legal origin ■ Scandinavian legal origin

Note: The values of the coefficients for the columns of Debt enforcement have been divided by 10 to improve the scale of the graph.

Government Regulation and Legal Origins

The values represent the average difference of the countries within each legal origin relative to the countries of the common law legal family. The values are the coefficient of each legal origin dummy in a regression that also controls for the Log of GDP per capita and a constant.

Legend: ■ French legal origin ■ German legal origin □ Scandinavian legal origin

Categories: Regulation of Entry, Regulation of Labor, Press Government Ownership, Conscription

Judicial Institutions and Legal Origins

The values represent the average difference of the countries within each legal origin relative to the countries of the common law legal family. The values are the coefficient of each legal origin dummy in a regression that also controls for the Log of GDP per capita and a constant.
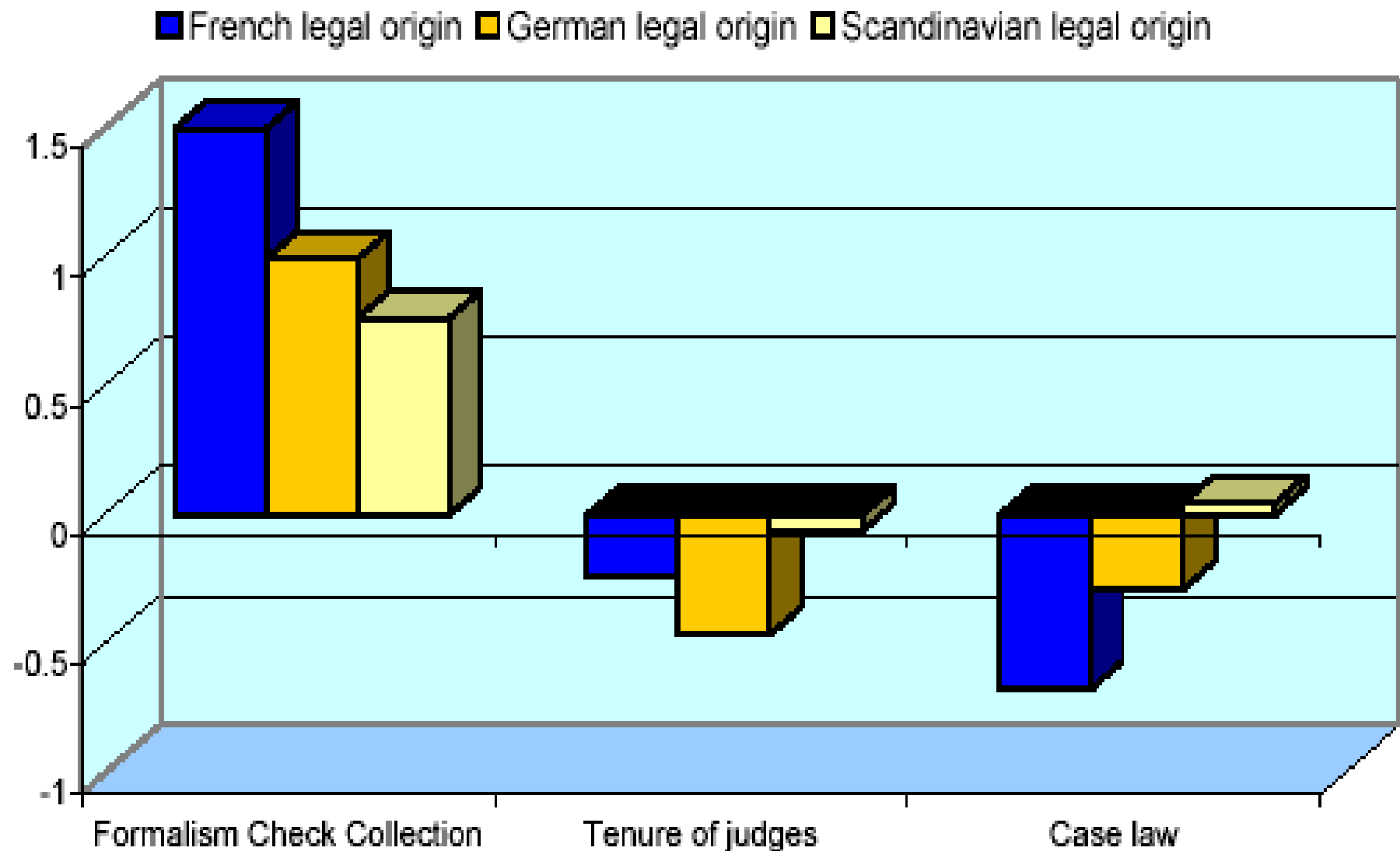
What is the explanation?

- Legal Origins as styles of social control

- Transplantation through conquest and colonization

- Enormous persistence over time

- Another predictor of variation: trust

- Generally speaking, would you say that most people can be trusted or that you need to be very careful in dealing with people?
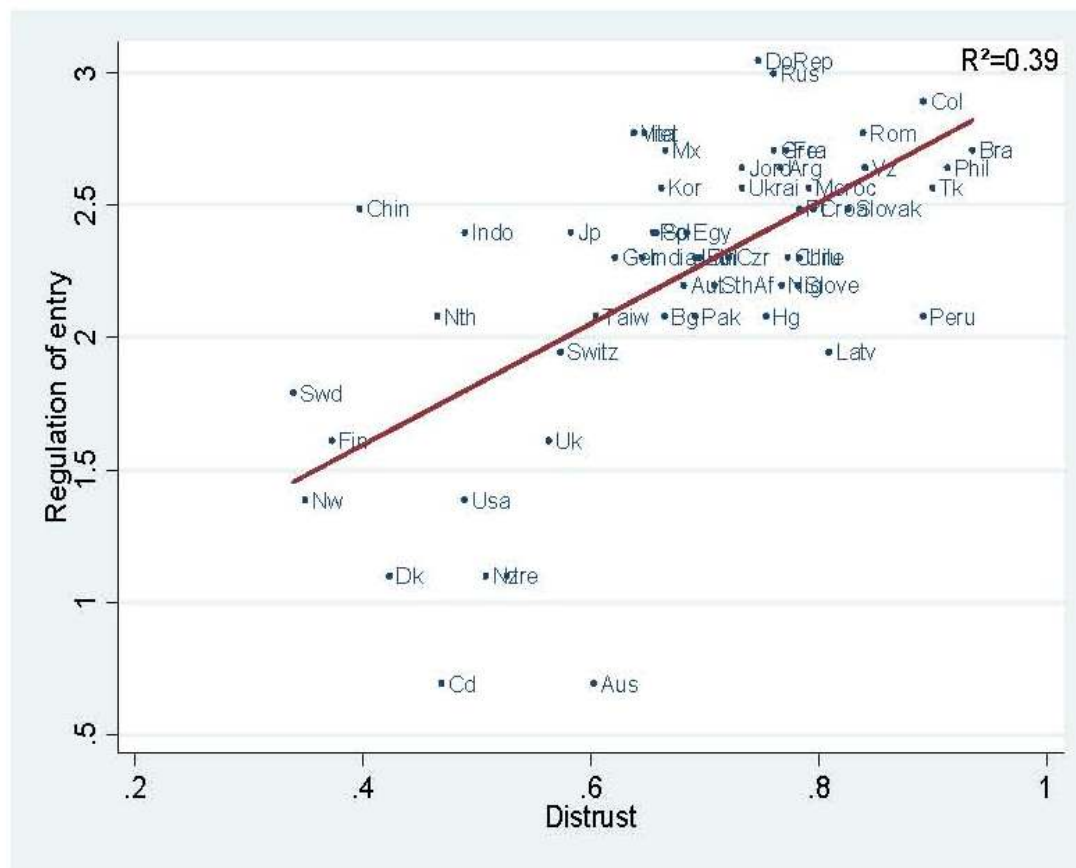
- Turns out to be a strong predictor of regulation

Figure 1: Distrust and Regulation of entry. Regulation is measured by the (ln)-number of procedures to open a firm. Sources: World Value Survey and Djankov et al. (2002).
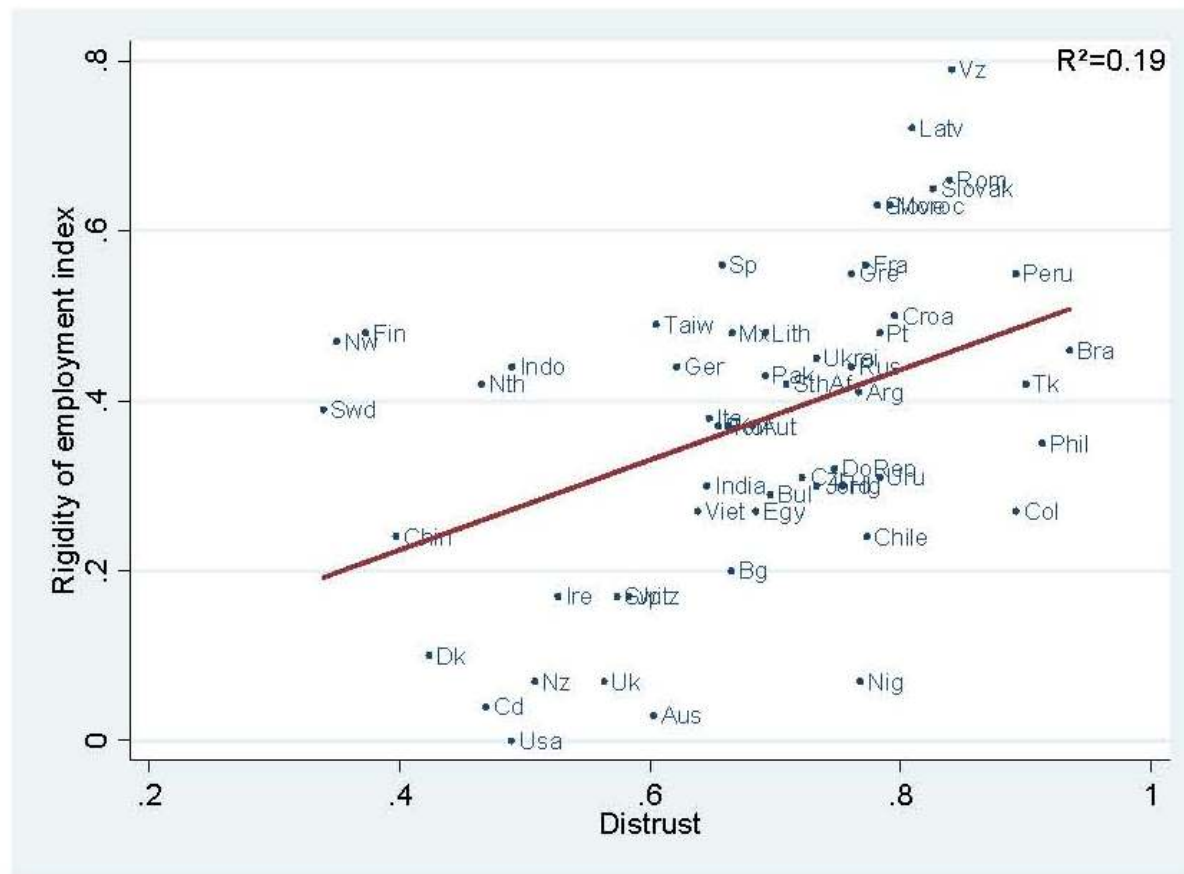
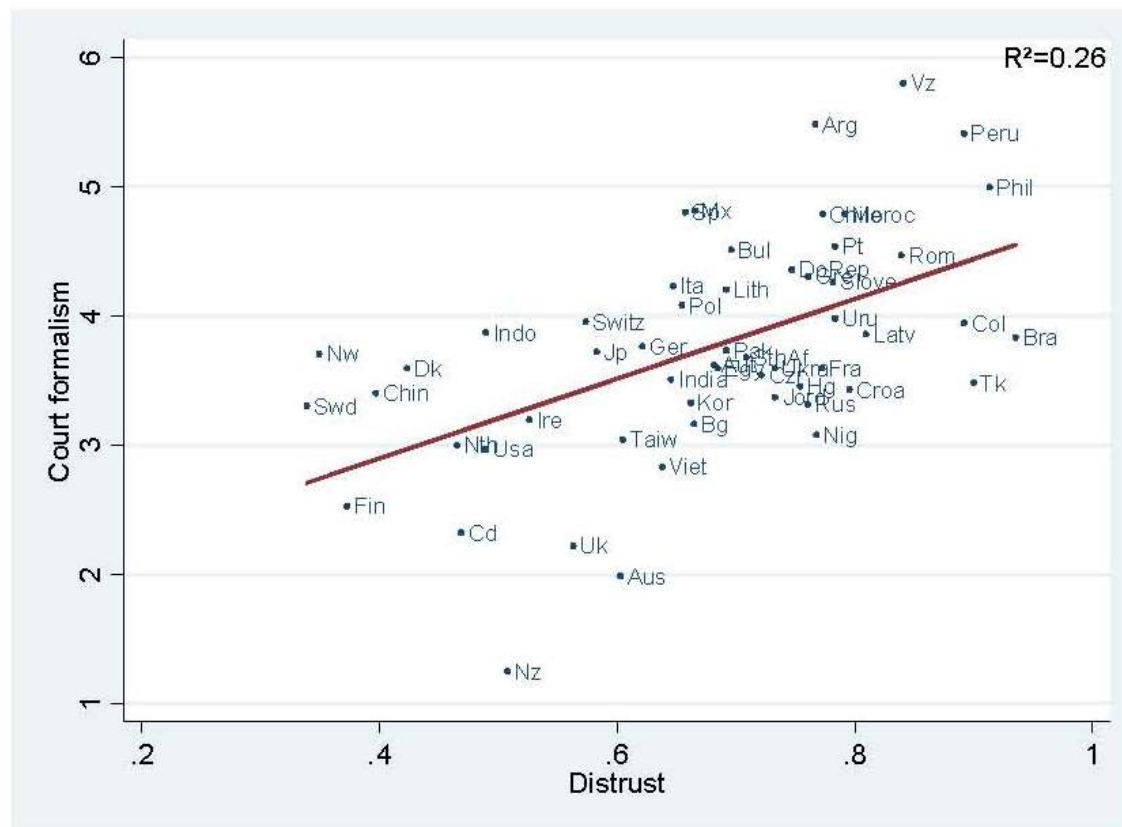Figure 3: Distrust and Rigidity of employment index. Sources: World Value Survey and Botero et al. (2004).

Figure 5: Distrust and Court formalism. The index measures substantive and procedural statutory intervention in judicial cases at lower-level civil trial courts in a case for evicting a tenant that has not paid rent. Higher values represent more statutory control or intervention in the judicial process. Source: Djankov et al. (2003).

What is the explanation?

Two directions of causality

- Distrust breeds demand for regulation

- Regulation breeds underinvestment in social capital, and distrust

- Evidence seems to be supportive

The Challenge of Understanding Regulation

- The normative case is difficult to make

- Experience with regulation in developing countries especially bad: it leads to corruption, not good outcomes

- Enormous cultural / legal variation

- All the more reason to try to understand both benefits and limits