Lecture 2. The Public Interest Theory of Regulation

The public interest theory of regulation claims that government regulation acts to protect and benefit the public. The public interest is "the welfare or well-being of the general public" and society. Regulation in this context means the employment of legal instruments for the implementation of policy objectives.

One of the most important consequences of the 'marginal revolution' of the 1870s was the development of a far more rigorous and formal welfare economics than was provided by the preceding classical analysis of economic policy.

The new theory was associated with theorists such as Walras, Pareto and Pigou. At its heart was an investigation of the properties of a general competitive equilibrium. In this Walrasian equilibrium all economic agents chose the amount of labour and other factors of production to supply and the basket of goods to consume by maximizing their utility at the prevailing perfectly competitive prices. These equilibrium prices were such that no aggregate excess supplies or demands existed in the market for any traded good or service. All markets cleared.

To demonstrate the existence of a general competitive equilibrium was a great intellectual achievement in itself but it was the normative properties of this equilibrium that came to form the basis for economic thinking about public policy to the present day. It could be shown that provided all goods and services were traded and that private benefits and costs were the same as social benefits and costs a perfectly competitive equilibrium was Pareto efficient. No one could be made better off without making someone worse off. The gains to trade were exhausted. Maximizing social welfare required the marginal social benefits of each and every activity to equal the relevant marginal social costs. Given that a condition for utility maximization on the part of each consumer was that the marginal benefit of a good or service should be brought into equality with its market price; and given that a condition for profit maximization on the part of each producer was that the marginal cost of a good or service should be brought into equality with its market price; and given that all consumers and producers faced the same market prices; it is possible to see quite intuitively how this theorem was derived. Equilibrium prices represented marginal benefits to consumers and marginal costs to producers.

The 'First Theorem of Welfare Economics' had very complex repercussions for public policy. It was capable of leading in two very different directions depending upon how it was interpreted. One response to the 'first theorem' was to argue that since perfect competition had such desirable properties, public policy should concentrate on removing impediments to competition. To the objection that competition might result in a very unequal distribution of income a 'Second Theorem of Welfare Economics' could be used to show that any desired distributional result could be achieved through appropriate lump sum taxes and transfers. Thus the recommended policy package was to achieve efficiency through competitive markets and equity through 'non-distortionary' taxes and transfers. In so far as economic regulation appears at all in this system it takes the form of competition policy.

An alternative response to the 'first theorem' was to emphasize the austerity of the formal conditions. No matter how 'competitive' the real economy seemed to those embroiled in its day-to-day tumult, it was obvious that it would never satisfy the requirements of perfect competition. Indeed, almost all competitive behaviour paradoxically could be shown to be incompatible with perfect competition. Price shading, for example, immediately contravenes the formal requirement that all contractors are 'price takers'. The introduction of new products or processes confers monopoly power for short periods.

Advertising would be redundant in a world of perfect information. If this were not enough, it was also clear that increasing returns to scale prevailed in some industries, markets were incomplete and the assumption of no external benefits or costs was unwarranted.

Viewed from this second perspective, the role of economic regulation was potentially very extensive. Markets did not have the characteristics of the perfectly competitive model and therefore could not be expected to achieve economic efficiency. Regulators were required to correct for 'market failure'.

Industries subject to declining costs required a subsidy since the marginal cost of extra output would be below the break-even price. Polluting activities should be taxed according to the external damage inflicted. Monopolies should be instructed to set prices equal to marginal costs. Jointly consumed or 'public goods' such as environmental quality and public information required the intervention of regulators to ensure an efficient level of provision.

In this tradition, therefore, regulators were seen as technicians acting in the public interest and correcting for the failures of the market. It was implicitly assumed that they had both the information upon which to act and the appropriate motivation. This idea of the professional public servant was also a requirement for the macroeconomic regulation that came out of the Keynesian revolution of the 1940s and 1950s. The economy was understood as a system of equations, the public objectives were well defined and the technical task was simply to control the values of a set of policy instruments so as to bring about the best possible result, social welfare maximization. Regulators were in the Platonic tradition of philosopher kings. Later criticism was to refer to these somewhat elitist assumptions of Keynes as 'the presuppositions of Harvey Road' – the Cambridge road in which Keynes was brought up.

Whether based upon general equilibrium theory or Keynesian macroeconomics, however, the role of the regulator is better described as Hobbesian. The sovereign authority is used to impose a solution where the social outcome would otherwise be disadvantageous because individuals are unable to come to enforceable agreements. The law is structured so as to 'minimize the harm caused by failures in private agreements'.