NoteWorthy

Regulatory Reform

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Our cover story addresses deregulation of electric utility markets. Electric utilities are the latest industry to be affected by a trend in regulatory reform that began two decades ago. Airlines, trucking companies, railroads, banks, and telecommunications firms that once operated under tight government regulation today compete more freely in open markets. The regulation of prices, entry and exit, and service in those industries had its origin in the creation of the Interstate Commerce Commission in 1887 to regulate the nation's railroads. Regulation spread to the communications, securities, trucking, and airline industries in the following century.

Traditionally, regulation was employed to curb the pricing power of firms in markets with significant economies of scale or scope. The concern was that a small number of firms would dominate such markets, so that competition could not effectively discipline pricing. In a nutshell, regulation was thought to substitute for competition in providing discipline. In addition, regulation promoted universal access to service at reasonable prices. For instance, lower electricity and phone rates for residential customers were paid for by higher rates for business customers. Mandated rate subsidization was possible only when the regulated firm was shielded from competition in market segments where it charged prices higher than costs.

In recent decades, economists have questioned the traditional view of regulation. Some have argued that regulation works not so much to protect consumers from monopoly power as to benefit regulated firms themselves. Barriers to entry by new firms in an industry allow regulated firms to enjoy higher profits. In addition, freedom from competition weakens the incentives for protected firms to control their costs, which can result in inefficient production of goods and services. Finally, economists have recognized that the threat of potential competition can be just as effective as the presence of active competitors in preventing firms from exploiting monopoly power. Leaving markets open to potential competition, however, means that there can be no cross-subsidization across different classes of buyers.

Economists' evolving understanding of the nature of regulation laid the foundation for the policy changes that followed. Regulatory reform began in earnest in the mid 1970s with the deregulation of the airline industry. The promise of lower airfares was particularly attractive in the high inflation environment of the time, and public support for deregulation was substantial. Airline deregulation set the stage for subsequent legislation in transportation, banking, and natural gas. The telecommunications industry also has been opened to increased competition through a series of actions, including the AT&T antitrust settlement of 1982 and the Telecommunications Act of 1996.

For the most part, deregulation has had the beneficial effects that economists predicted. Deregulation generally leads to lower prices as competition wrings out inefficiencies and makes companies more alert to customer needs. It is true that the loss of subsidized pricing may disadvantage some buyers, at least initially. Undeniably, the benefits of competition fall unevenly across market segments.

The potential for competition, however, encourages technological innovation as existing firms seek to hold onto market share and new firms seek a market foothold. These longer term effects mean that the long run benefits of deregulation are indeed widespread. Finally, regulatory reform often opens the door to rapid change in industry structures. While the consolidations that have followed deregulation in many industries can easily grab our attention, they should not distract us from the ultimate goal of more efficient markets.

Al Broaddus

Al Broaddus
President,
Federal Reserve Bank of Richmond