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# REGULATION AND CONTROL VS. DEREGULATION AND DECONTROL

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## I. INTRODUCTION

In this century, governments increased the scope of their regulations and controls to market a great deal. In the late 1970's, economists began to argue that regulations and controls into the market impose some important costs to the society. They argued that deregulation and decontrol policies should be implemented. In this study, I shall try to make an analysis of deregulation and decontrol versus regulation and control.

## II. THE CONCEPTS OF REGULATION/DEREGULATION AND CONTROL/DECONTROL

Deregulation and decontrol are two important policies to strengthen free market economy. The former means termination of all kinds of "public regulations" within various sectors or industries. The latter explains that all type of "Public controls" be abolished. Both Public Regulation and Public Control are broad concepts in the sense that they define the various ways, in which government may intervene directly to the activities of the economic agents. Some of these regulations and controls require economic agents "to do", or "not to do" or "get permission to do" some activities. Public regulations and controls would be either "administrative" or "economic". (see: Table:1) Some examples for administrative regulations and controls are; traffic regulation, taxation, conscription etc. Economic regulations include such practices carried out by the government as awarding occupational licensure, patent, franchise, tariffs and quotqs for international trade etc. All kinds of direct intervention in the natural functioning of supply and demand, such as, price , rent , interest, wage control etc. are also examples for "economic" controls within the national economy.

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Table Type of Public Regulation and Public Control

| Public Regulation | | Public Control | |
|---|---|---|---|
| Administrative Regulation | Economic Regulation | Administrative Control | Economic Control |
| -Taxation | -Legal barriers to entry to the market (Public monopoly, franchise, occupational licensure and patent) | Auditing of taxpayers | -Price control |
| -Conscription | -Legal barriers to international trade (tariffs, quotas etc.) | -Traffic Control<br>Environmental control<br>Health Control | -Wage control<br>-Rent Control<br>-Interest rate control (usuary law) |
| -Traffic regulation (compulsory seat belt | -Subsidies of public economic enterprises | | -Exchange rate control |
| -Compulsory elementary education | -Compensating "duty loss" of public enterprises | | |
| -Prohibition of using drugs | -Rescue operation for private firms in bankruptcy. | | |
| -Standardization in products. | | | |
| -Environmental regulation | | | |

## III. THE RATIONALE FOR REGULATION AND CONTROL

Economic arguments for regulation and control derive from the perception that there are "failures" in the working of the market, so that the level and/ or composition of output determined on the private decisions does not maximize welfare (Pera, 1989; 166) Arguments for economic regulation and control are based on the views of orthodox welfare economists. It has been argued that economies of scale and external economies are two important reasons of government intervention to market directly or indirectly.

**Economies of scale** exists when the long-run average costs continue to decline as firm size increases. Thus, a larger firm, is believed has always lower costs. In other words, cost of production would be the lowest when a single firm produced the entire output of the industries, where economies of scale reign. Such industries as postal and telecommunications services, electricity, gas, water supply, transportation (especially, railways) etc. are the typical examples, in which economies of scale occur. Theoretical welfare economists argue that since a single firm (monopoly) makes optimal use of the resources in the national economy, it would be desireable. They go on to say that consumer interests can be exploited if the natural monopolist is a private firm. Because, private monopoly tends to maximize its profits by cutting down the production and therefore raising the prices. In such cases, government would be desirable to produce and supply the goods and services as a natural monopolist. In sum, the reason behind the direct intervention of government to the market is due to economies of scale.

The second reason of the government's intervention to the market is due to **externalities**, which may derive from both consumption and production activities of economic agents. A government intervention is expected to punish the economic agents in the case of negative externalities and correct them. On the other side, government is also expected to extend subsidies to those economic agents, whose production or consumption activities generate positive externalities.

Theoretical welfare economists see externalities as one of the sources of "market failure". Pigovian taxes - to correct the external diseconomies- and subsidies - to encourage the activities, which generate positive external economies- are accepted as the two most important tools of "benevolent

government."

Besides the arguments proposed by traditional welfare economists, there are some other reasons for public regulation and control. Government sometimes puts some legal barriers to entry to the market. Occupational licensure, patent and Public franchise are the examples of these types of barriers. Licensing is a process, through which one obtains permission from the government to enter a specific occupation or business. In some countries, a person must obtain a license before he can operate in some specific kind of businesses such as, barbershop, taxicab, drugstore, liquor store etc. Occupational licensure often limits entry to the market. Patent is also a legal barrier to entry. Government gives an exclusive right to the owner of a newly invented product or process for a limited period of time. Patent is an intellectual property right given to the holder of an innovation or novelty. Government sometimes grants a franchise to a private firm for the provision of a good or service. Public franchise excludes competitors from providing that goods and service.

Artificial trade barriers (including taxes imposed on goods called "tariffs" and limitations or prohibitions on imported items called "quotas") are also public regulations in the field of international trade. The main reason for these types of regulation is protectionism, which refers to protecting domestic infant industries from outside competition.

Finally some types of economic controls, such as price, rent, wage controls exist. Government may want to administer the prices in the market. Normally, the prices of the means of the production can be determined via supply and demand. Some economists claim that government intervenes in the market for such controls in an aim to protect consumers, tenants, savers, wage earners etc.

## IV. THE COSTS OF REGULATION AND CONTROL

We have explored the arguments in favor of regulation and control in the previous section. Now, let's look at the other side. What are the disadvantages of regulation and control ? What costs to regulation and control impose on individuals and society ? It has been advocated that regulation and control brings various types of costs on individuals and national economy, as a whole. Each type of public regulation and control results in some specific effects. In the following, I shall sum up the most important costs of regulation and control.

As noted earlier, certain industries considered natural monopolies such as railways, postal and telecommunication services, electricity, gas and power supply are usually provided by public utilities in many countries. A natural monopoly industry is usually turned over a statutory monopoly. Or sometimes government may give an exclusive right to a firm allowing it to provide goods and services.

Monopoly, whether private or public, causes a welfare loss in society. Because a monopolist tends to reduce output and thus increase price and profits. This attitude of monopolist results in "**contrived scarcity**" in the marketplace. The contrived scarcity is actually a social cost to the economy. The effects of a monopoly can be analyzed via Figure: 1

Figure: 1 (a) illustrates the hypothetical case of converting a competitive industry into a monopoly. Assuming that industry initially has competiton and a long-run equilibrium is established at E, where industry demand and supply are equal. In this case. the price is equal to the long-run marginal cost of production. At this equilibrium point E, consumers are willing to pay the amounts given by the demand curve, but they pay only Pc. They thus receive a surplus of real income in this case represented by the large area above the industry supply curve and below the industry demand curve or CEPc. This triangle represents the "**consumer surplus**", which is the amount that consumers would be willing to pay over what they have to pay for a commadity.

Now, let's go some further and try to find an answer to this question: What happens if the competition is eliminated. Suppose that industry is turned over a monopolistic position. At this case, monopolist can create "contrived scarcity" by limiting output to Qm and increasing the price to Pm. At this level, consumer surplus shrinks to the areas CAPm. (See:Figure: 1 (b) ) As a result of this, monopolist's profits expands. The area of monopolist's profits (PmABPc) can be considered a transfer from consumers to the monopolist. (See : Figure: 1 (c) )

On the other hand; the triangle AEB is simply lost to everyone. It is neither transferred to monopolist in the form of profits nor retained by consumers as consumer surplus.

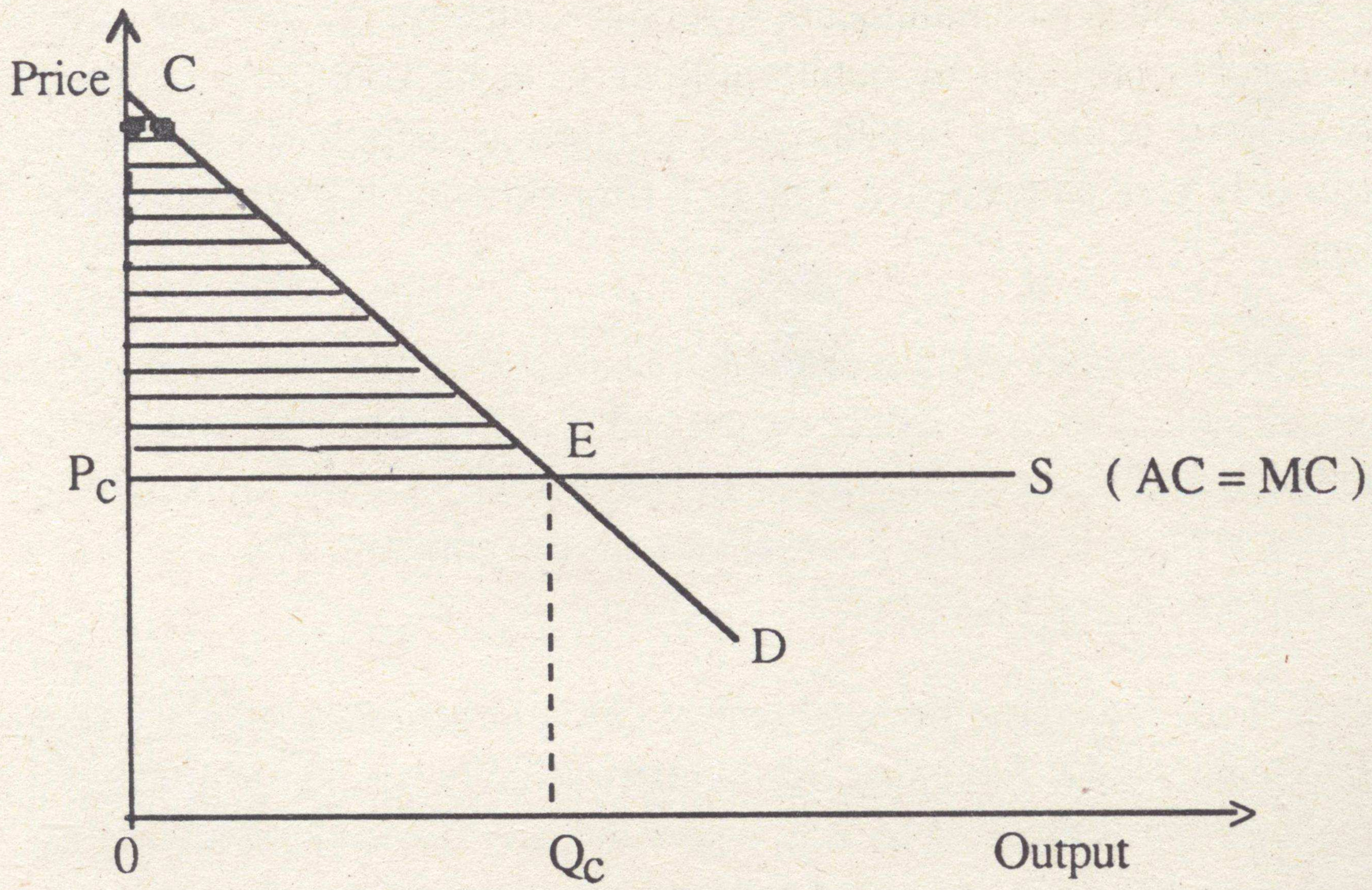


Figure : 1 (a) Consumer Surplus in a Competivite Market

This area represents the welfare loss due to monopoly. It is a loss because it vanishes when a monopoly is formed. It is a cost to the economy because it does not reappear as income to someone.

The second cost of the monopoly is the total value of the resources used to capture monopoly profits. This is called "**rent-seeking**", which became a hot topic in the economics studies in recent years. Now, let's analyze rent seeking cost of monopoly first. After that, I shall search the rent seeking in its broad sense. As noted earlier, the area PmABPc represents the monopoly profits, a simple transfer from consumers to the monopolist. The question arises here: What happens if people compete for these transfers?

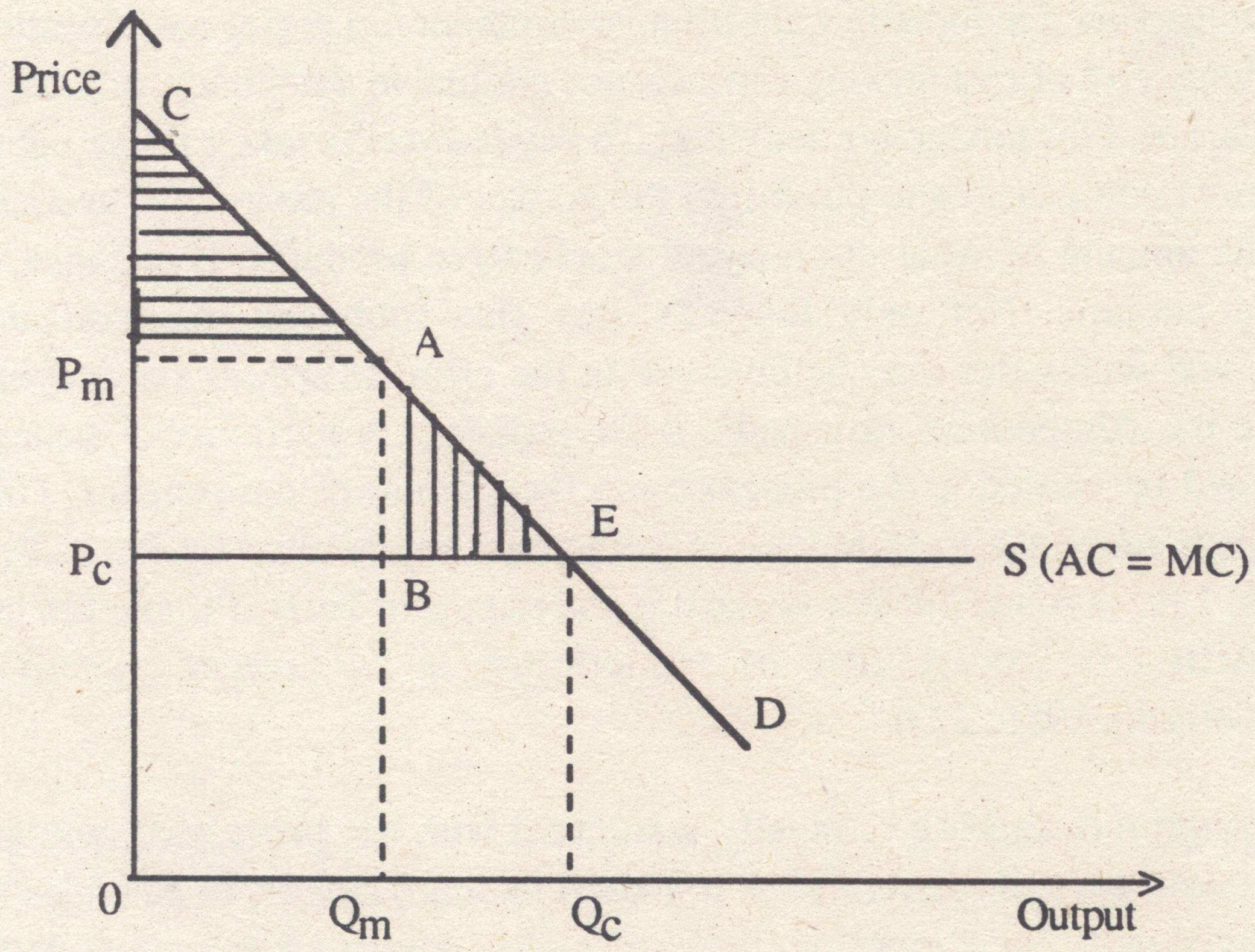


Figure : 1 (b) Consumer Surplus in a Monopolistic Market

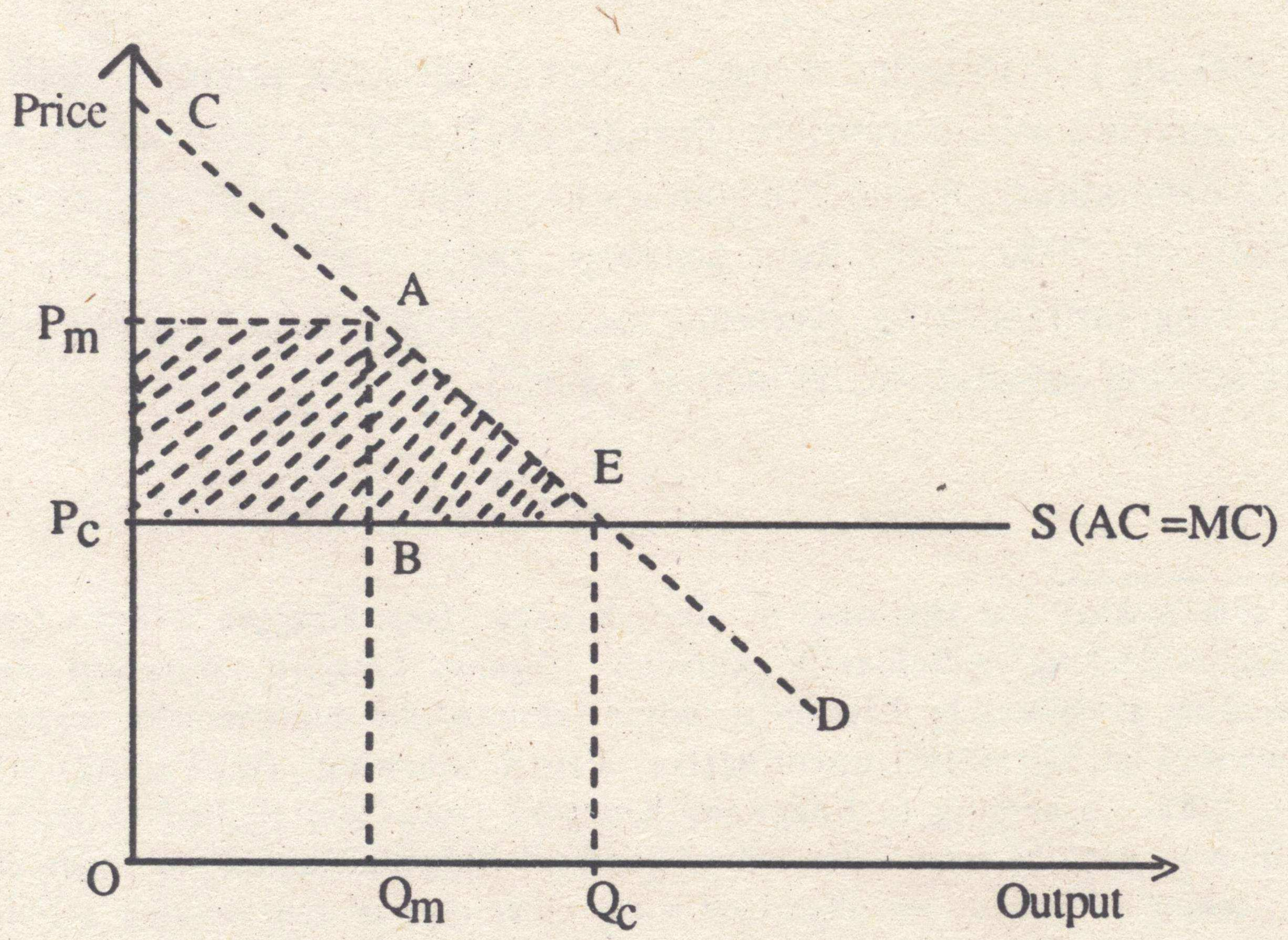


Figure : 1 (c) Social Cost of a Monopoly

Suppose that some individuals or companies lobby with government to obtain a monopoly privilage, hence have a monopoly profit. Expenditure of resources to capture a monopoly right from government is a social cost. Because the oppurtunity cost of rent seeking expenditures is equal to the money, that could otherwise be spent for productive activities. To pay lawyers to take a dollar out of the pockets of consumers and put it into the pocket of the monopolist reduces GNP by the amount of what the lawyers would have produced if engaged in productive pursuits. Not only lawyer's, but also lobbyists, accountants, executives and secretaries may be involved in the effort to secure a monopoly transfer. If the competition to capture these transfers is sufficiently strong, resources will be wasted in the process up to the amount of the transfer. This amount, when added the welfare loss, is the amount represented by PmAEPc. (see Figure: 1 (c) .) When the loss is equal to the trapezoid PmAEPC and not the triangle AEB, the social cost of monopolies is no longer small. (Ekelund-Tollison, 1986; 223)

Although rent seeking is usually associated with the process of seeking monopoly privilages from government. It, indeed includes all kind of activities of spending resources in competing for artificially contrived transfers from government. In this sense, "**monopoly seeking**" is just one kind of efforts to obtain a transfer

Rent seeking (1), in broad sense, is used to describe attempts both to obtain and to maintain wealth transfers (Pasour, 1987; 123) In other words, rent seeking is the expenditure of scarce resources to capture an artificially created transfer. (Tollison, 1982; 578) Rent seeking takes many forms, such as monopoly seeking, tariff seeking, Premium seeking, grants/ subsidy seeking etc. Types of rent seeking activities are defined in Table: 2

(1) The term rent seeking was first used by Anne Krueger. (see: Krueger, 1974) referring only to "Quota Seeking" activities of economic agents. Later on, Bhagwati argued that rent seeking as defined by Krueger is only a subset of the much broader concept of what he defines as **Directly-Unproductive Profit Seeking (DUP) Activities.** (Bhagwati, 1982). According to Bhagwati, Krueger's study was limited to the rents resulting from quotas, the issue indeed more general." Bhagwati argued that there could be "tariff seeking", "revenue seeking", and some other type of rent seeking activities, He prefered to use the term Directly Unproductive Profit Seeking (DUP) Activities in an aim to include all kinds of welfare seeking activities.

The most important conclusion to be drawn from "rent seeking" or "**welfare seeking**" theory is that expenditure of resources to obtain artificially contrived transfers is a social cost. As a mutter of fact, The efforts to obtain transfers from government are legal up to a certain point. However, when there is a strong competition, rent seeking takes some other "illegal" forms

Table: 2 Type of Rent Seeking Activities

| Type | Definition |
|---|---|
| 1. Monopoly Seeking<br>Tullock (1967)<br>Bhagwati (1982)<br>Posner (1975) | Economic agents compete for obtaining a pure monopoly right from government. |
| 2. Tariff Seeking<br>Bhagwati (1982)<br>Brock and Mages (1978)<br>Feenstra-Bhagwati (1982) | Economic agents lobby for the imposition of a tariff on import goods. Hence, domestic producers can maximize their profits via changing a price higher than its marginal cost. |
| 3. Quota Seeking<br>(License Seeking)<br>Krueger (1974)<br>Bhagwati and<br>Srinivasan (1980)<br>Bhagwati (1982) | At first level, economic agents lobby to expand the size and scope of Quantitative Restrictions (QRs). At the second level, economic agents deplore efforts to obtain a licence for importation. |
| 4. Transfer Seeking | Private interest groups lobby for obtaining subsidy in the form of, for example, low cost loans, loan guarantees etc.<br>Some public interest groups or not-for profit organizations lobby for obtaining grants from governments in variety areas. |

such as bribery, tariff evasion or smuggling etc. As noted by Krueger, "in many market- oriented economies, government restrictions upon economic activity are persasive facts of life, These restrictions give rise to rents in variety of forms, and people often compete for the rents. Sometimes, such competition is legal. In other instances, rent seeking takes other forms, such as bribery, corruption, smuggling, and black markets. " (Kruueger, 1974; 291)

Now, let's try to find an answer to the following question: How large are the welfare losses due to regulatory activities of government. As a matter of fact, several empirical studies searched the costs of regulaton and rent seeking. One of the earliest empirical study by Professor Arnold Harberger estimated the welfare loss in the manufacturing sector of the US economy due to monopoly about 0. 1 percent of GNPin 1929. (Quoted in: Ekelund and Tollison, 1986; 222) Richard Posner's study, however raised this percantage up to 3 percent in 1970's (Posner, 1975)

On the other hand, Professor Weidenbaum estimated that as of the mid-1970's, the annual cost of regulatory activities in the US was $ 103 billion, more than 5 percent of GNP. As with other costs, the burden is passed on the consumer in the form of higher prices. For example, Weidenbaum estimated that equipment mandated by regulatory activities adds $ 1500 and $ 2500 to the price of a new home. (Quoted in: Gwartney and Stroup, 1980; 475)

Another study by William Simon concluded that an estimated 130 billion man-hour were being spent filling out bureaucratic forms at a cost of at least $ 25 billion. That sum being added to the basic price of America's goods and services. And government processing of that paperwork cost taxpayers a minimum of $ 15 billion more. (Quoted in: Gwartney and Stroup, 1980; 583)

Laband and Sophecleus made an estimation of a welfare loss due to rent seeking and concluded that "our crude estimate of the impact of rent seeking suggests that rent-seeking, as we measure it, costed the economy an additional 22.6 percent of measured GNP in 1985. " (Laband and Sophecleus, 1987; 127) They continue to say that "... our results are suggestive at best, owing to the inherently difficult task of measuring rent seeking with any degree of accuracy. ... our time series estimates suggest that the cost, in terms of foregone GNP, of the rent seeking activity embodied in each 1000 American Bar Association (ABA) registered lawyers is approaximately $ 2.6 billion in 1982 Dollars. To put these

numbers in perspective, consider the fact that in 1985 there were 311.290 ABA registered lawyers; an associated economic loss due to the proxied rent seeking comes to cost over $ 902.5 billion, in 1985 dollars; roughly 22.6 percent of measured nominal GNP for that year. (Laband and Sophecleus, 1987; 132)

An estimate was also made for two developing countries, India and Turkey by Anne Krueger. Krueger estimated that the welfare loss reached an about 7.3 percent of national income for india. For Turkey, she concluded that "the rents from import licences in Turkey in 1968 were about 15 percent of GNP." (Krueger, 1974; 294)

The basic message and conclusion of public choice economics is that rent seeking occurs primarily through the political process and the best way to limit rent seeking is to impose limits on the powers of the government. Nobel prize winner james M. Buchanan stresses on an important point: "Rent seeking... has been with us always, and there is surely no prospect that it will fade away. Behaviourally, rent seeking has become more important because institutional changes have opened up oppurtunities that did not exist in the nineteenth century and early twentieth centuries "(Buchanan, ; 1980; 3) He went on to say that "... (As) institutions have moved away from ordered markets toward the near chaos of direct political allocation, rent seeking has emerged as a significant social phenomenon. " (Buchanan, 1980; 4) According to Buchanan as well as to other public choice scholars, "reform in the rent seeking society depends on general constitutional changes in the whole structure of social and economic institutions. " (Buchanan, 1980 (b) ; 367)

Now we have reached a conclusion that regulation imposes several costs on individuals and on society as a whole. The first cost is welfare loss due to regulatory activities of government. The second is rent seeking cost. Legal competitive rent seeking is obviously a social cost, because the oppurtunity cost of "legal" rent seeking activities is very high. Rent seeking expenditures do contribute nothing to the GNP, by contrast, it reduces GNP by the amount of what the rent seeking society would have produced if they engaged in productive activities. In brief, rent seeking on the first level, although it is legal, is wasteful. At the second level, the process is illegal, because rent seeking takes such forms as bribery, corruption, smuggling etc. to capture wealth transfers from government.

There may be some other costs that regulation imposes on individuals and economy. Regulation of publicly owned enterprises bring x-inefficiencies. In a private enterprise, both internal control (by the shareholders) and external control (by the capital market) provide incentives to avoid inefficiency. Share holders monitor managers to ensure that they maximize income, if managers fail to do so, shareholders will sell their shares, while other managerial groups will bid for the control of the company in the belief that they will be able to obtain a better return from the company's resources. In a public enterprise, capital market monitoring does not work, while internal monitoring will be performed by politicians who are not necessarily interested in how efficiently managers allocate resources (Pera, 1989, 170) On the other hand, x-inefficiencies arise due to monopoly status of some publicly owned enterprises (POEs). There is obviously no competitive pressure to minimize the costs of production for public utilities, which have monopoly status.

Lack of incentives for workers and managers are the other sources of x-inefficiencies in publicly owned enterprises. As a matter of fact,. there is no direct linkage between the profitibility of the firm and the incomes of the workers and managers in POEs. So, work effort will be less in POE than a private enterprise. Another thing is that the public enterprise will not be driven out of business if fails to achieve productive efficiency. In sum, higher production costs caused by x- inefficiencies are another social cost of monopoly and of regulation.

## V. THE BENEFITS OF DEREGULATION AND DECONTROL

Recent contributions and developments in the economics of regulation proposed that all kind of government regulations and controls into the market should be terminated. On the other hand, the new economic theories based on laissez-faire principles of classical liberalism advocated free market economy strongly and criticized the regulatory policies of government. In the beginning of the 1980's, with the struggle of conservative capitalism-Reaganomics and Thatcherism mainly-free market has been a popular movement all over the world. Many industrial and developing countries has taken some measures to strengthen free market economy. As a matter of fact, deregulation and decontrol has become one of the most important reforms in many countries. OECD, for example urged its member countries to take deregulatory measures in 1979 and since then, most OECD countries have implemented deregulation in some sectors, in particular, transport, postal and telecommunications, broadcasting, energy, banking. A study by OECD in 1985 concluded that "in general... deregulation has increased

efficiency, reducing the costs of services and raising productivity in member countries. (The OECD observer, 1985; 17., see also Pera, 1989)

A study by Robert Okun, which searched the consequences of deregulation in USA concluded that: "economic deregulation is the first major victory of free market economics in American Public Policy, and it sets an important precedent. Since the New Deal, economic advances in the United States have been equated with bold government initiatives. Spectacular benefits of deregulation have shown the progress that can come from reducing government's role rather than enlarging it. By liberating price controls and permitting competition, the deregulation revolution has allowed entrepreneurs to find the most profitable ways of serving costumers." (Okun, 1986; 29)

Empirical studies show that deregulation has brought competition and consequently lower prices, greater efficiency and effectiveness and technological advancement in many industries. (See Bailey, 1986., The OECD Observer, 1985., Pera, 1989)

Deregulation and decontrol resulted in also positive effects on small businesses. Devastating natural monopolies and implementing measures to make entry easier increased the number of small businesses and employment. An empirical study by Bruce D. Phillips concluded that deregulatory measures taken in the transportation, finance and communication sectors in US during the 1976-1982 have resulted in increasing share of total sales, number of new firms and total employment in small businesses. US regulatory agencies, such as Interstate Commerce Commission (ICC), the Federal Communications Commission (FCC) and the Civil Aeronautics Board (CAB) implemented such measures as repealing the rules that set prices terminating restrictions of new competitors into the airline, trucking, railroad industries and financial services.

According to the Phillips study, a dramatic change occured in the number of small businesses in deregulated industries. There were 988.251 jobs generated in the US economy between 1980-1982. About 31 percent, or 724.390 of these were in recently deregulated industries. Small businesses which are defined as having fewer than 100 employees, contributed 82.6 percent, or 598.395 of these jobs in the deregulated sectors. In some of the deregulated industries, such as air transportation, trucking and communication, large firms with over 500 employees lost employees between 1980 and 1982. By contrary, small businesses with

under 20 employees more than compensated for the loss in large firms. In trucking, for example small businesses under 20 employees gained 61334 jobs while large businesses with over 500 employees lost 74.812 employees. (Phillips, 1985; 30)

In terms of new business formation, there was an increase of 19233 establishments in deregulated industries between 1980 and 1982. Small businesses under 20 employees contributed 100 percent of these new establishments in the aggregate.

## CONCLUSION

Since the beginning of last decade, many industrial and developing countries have been implementing some policies toward free market economy. One of the most important policy to foster and initiate free market is privatization. There are many techniques of privatization through which free market can be strengthed. One of these is deregulation and decontrol. In this study, I have first analyzed the advantages and disadvantages of the regulation and control. After that, the benefits of deregulation and decontrol are summed up. In light of this study I can conclude that deregulation and decontrol has brought competition and consequently lower prices, greater efficiency and effectiveness and technological advancement in many sectors of industrialized and developing countries. Moreover, some small businesses in particular have benefited from the deregulation of certain industries. The number of small businesses and employment have increased as a result of deregulatory measures.

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