

Five Prisms of Economic Analysis

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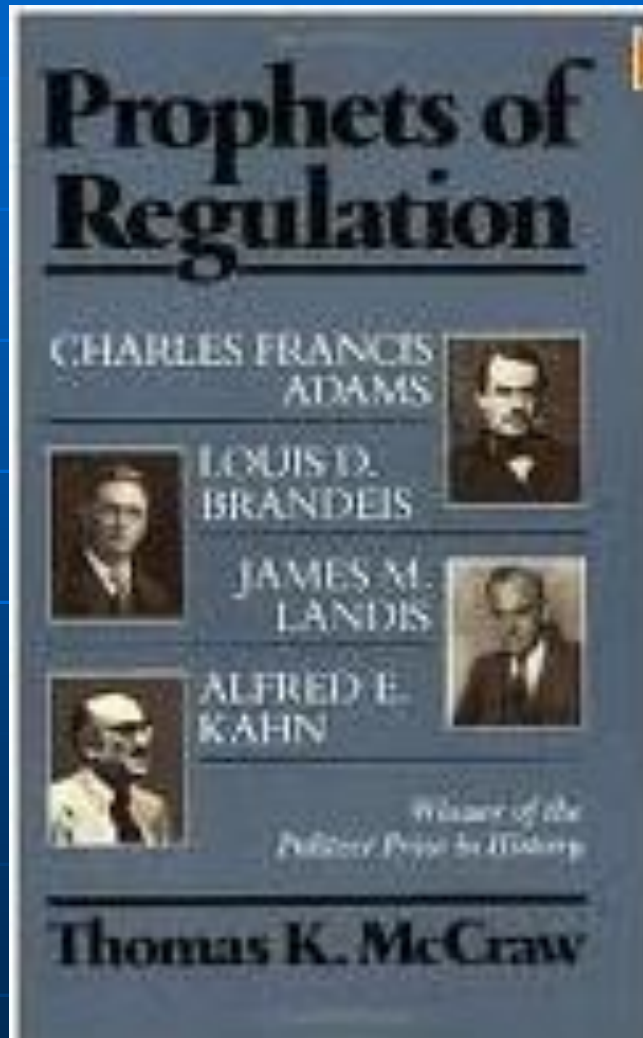
I·R·L·E

INSTITUTE FOR REGULATORY
LAW & ECONOMICS

How is regulation legitimate?

- “Public Interest”
 - Rule of stronger?
 - Crony corporatism?
 - Normative economic basis
- Economic basis aspires to correct, and is tempered by:
 - Monopoly problems
 - Externality Problems
 - Agency problems
 - Information asymmetries

Prophets of Regulation



What were they trying to solve?

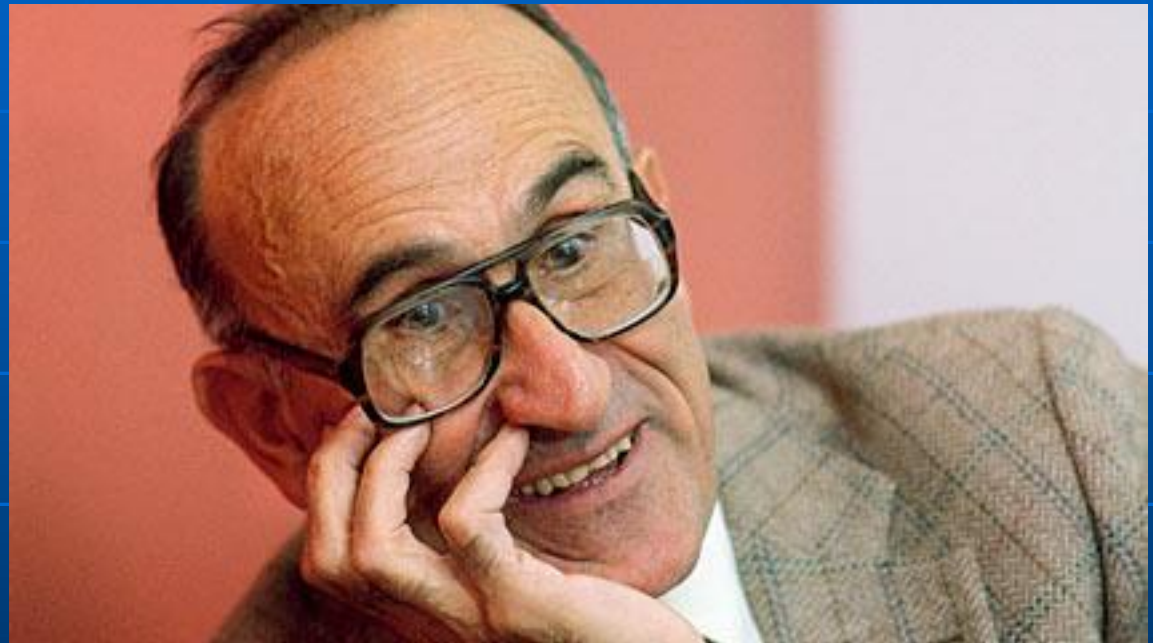
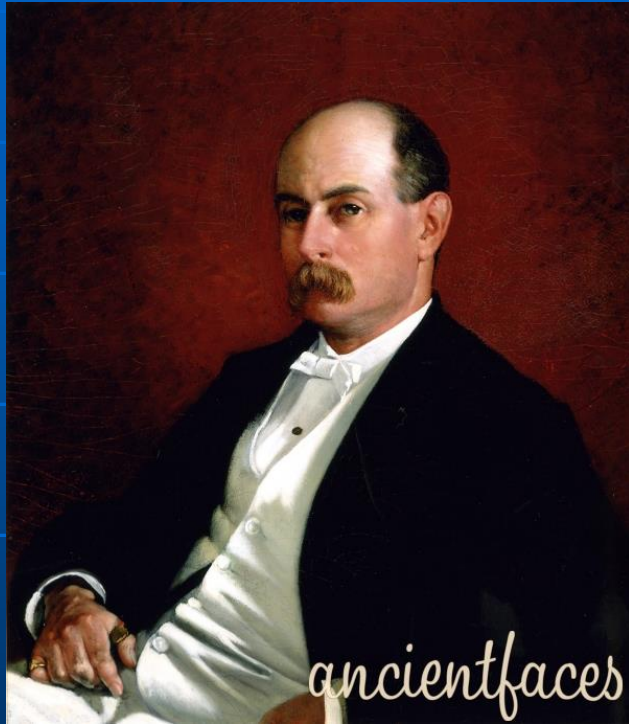
What institutions emerged to solve the problem?

What affect did regulation have on the industry and economy?

What interests emerged to stifle, direct, promote or hinder regulation?

What institutional responses can limit special interest capture, dynamic senescence, regulatory caprice?

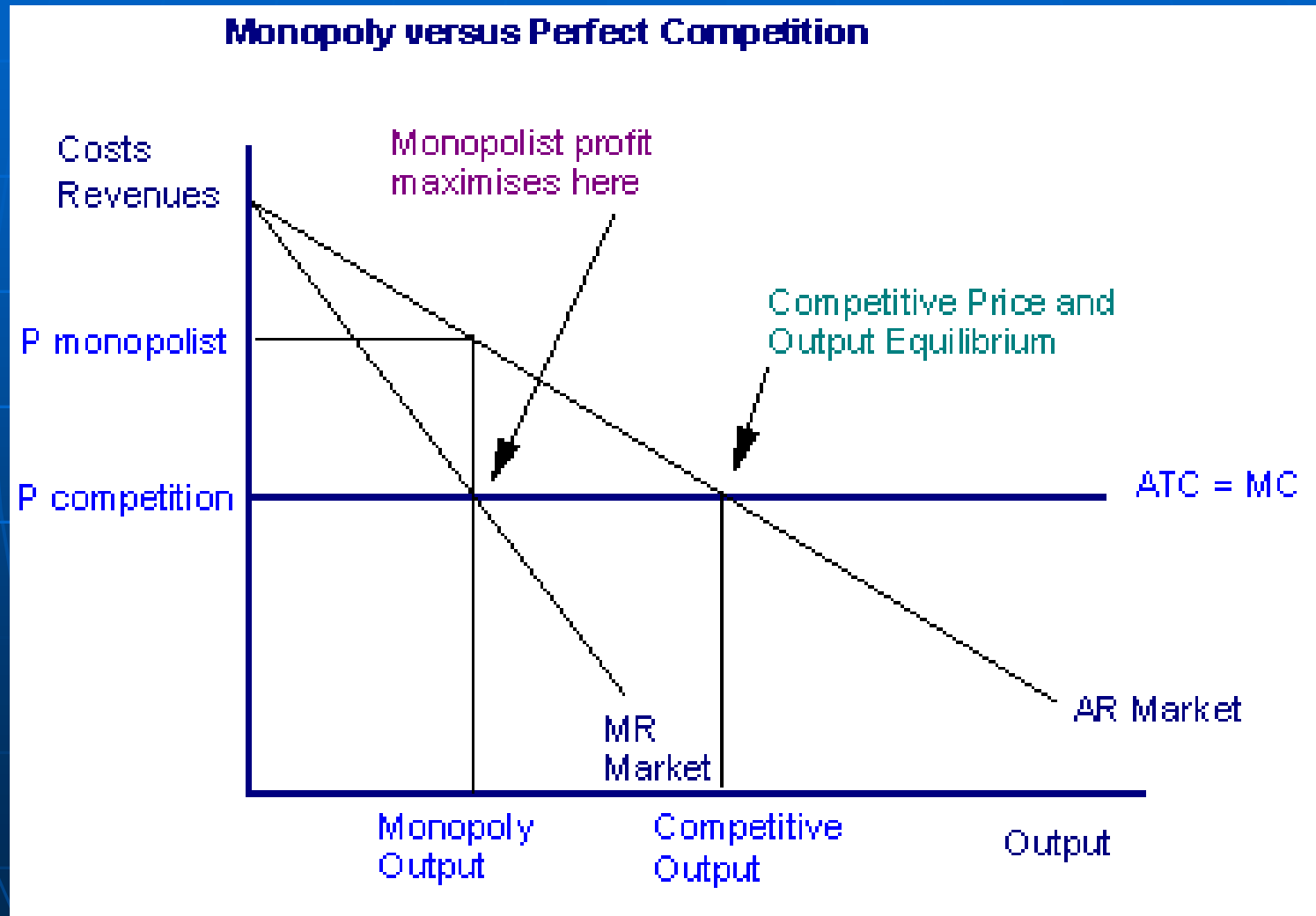
Adams and Kahn



The Five Prisms

- **Neoclassical Economics**
- **Schumpeterian Dynamism**
- **New Institutional Economics**
- **Public Choice Theory**
- **Code As Law -- Postmodern
Non-Economics**

1. Neoclassical Economics





2. Schumpeter

Dynamic -- not static efficiency of the neoclassicist -- is what matters in a capitalist economy

Competition *for* the market is more important than competition *in* the market

Capitalism is a process of creative destruction

But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest-scale unit of control for instance)–competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives. This kind of competition is as much more effective than the other as a bombardment is in comparison with forcing a door, and so much more important that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly; the powerful lever that in the long run expands output and brings down prices is in any case made of other stuff.

It is hardly necessary to point out that competition of the kind we now have in mind acts not only when in being but also when it is merely an ever-present threat. It disciplines before it attacks. *Capitalism Socialism Democracy* pp 82-84 (Harper 1942)

3. New Institutional Economics

Coase, Demsetz, Smith, Kahneman, Williamson: neoclassical analysis not sufficient, methodologically focused on how people and institutions behave in practice

Coase Theorem: When transactions costs are zero, the initial allocation of property rights does not matter because parties will bargain to the efficient outcome

Takeaways: institutions, transactions costs, externalities, definitions and enforcement of property rights matters

Marginal Cost Problem: neoclassical competition theory is insufficient to explain behavior and challenges of high fixed/low marginal cost enterprises.

Behavioral Realities: Bounded rationality, information asymmetries and opportunism

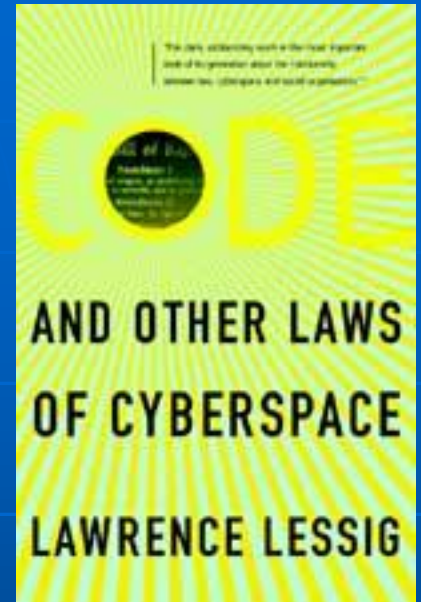
Smith: Markets are efficient, more or less, despite irrationality and information asymmetries, depending on governing institutions (rules)

4. Public Choice Theory

- Regulation is “acquired by the industry and is designed and operated primarily for its benefit.” George Stigler. To the extent that there is a market for rents—i.e., regulators divide up producer and consumer surplus (or surplus value between producers)—parties will engage in “rent-seeking” behavior.
- Regulation is a means for firms to advantage selves and disadvantage rivals
- Buchanan and Tulloch identify the general case; Stigler applies to regulation
- Posner: Regulation is not about monopoly control, but “taxation by regulation”

5. Code is Law

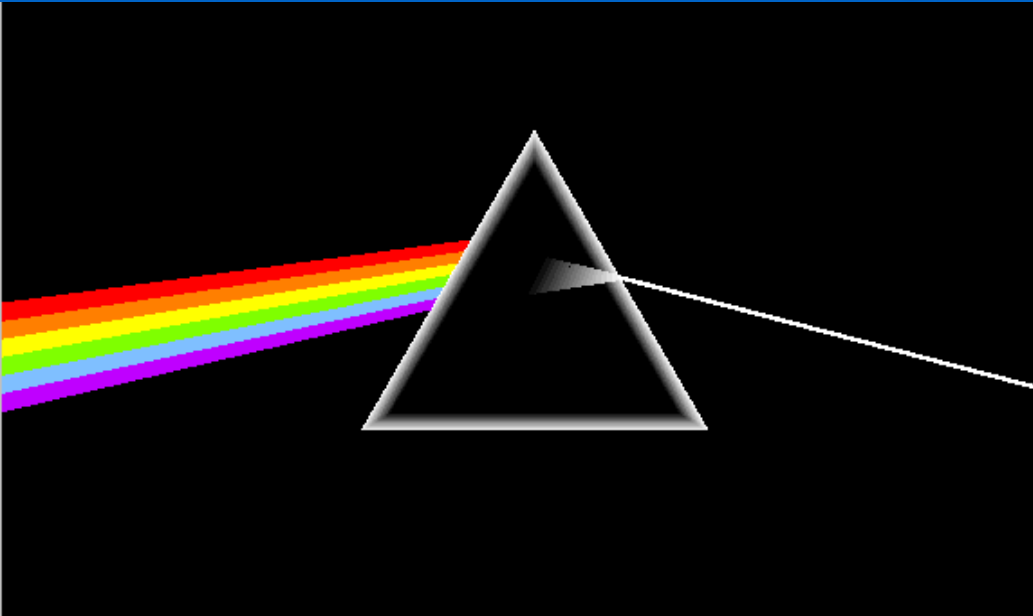
- **Architectural decisions have normative consequences**
- **Postmodern challenge to economic claims of efficiency**
- **Argues for public control over architectural decisions**
 - Economic analysis lacks a normative basis to assert what decisions are “best”



Five Prisms and Networks

- Networks Present Common Dilemmas
 - High fixed, low marginal cost
 - Positive Network Externalities
 - Powerful returns to scale and scope
- Horizontal
 - Interconnection, its pricing and monopoly problems
- Vertical
 - Solve holdout, pricing and complementary good problems
 - Presents discrimination and access concerns

Path through the prisms



Schumpeter

Finance

Neoclassical

Public Choice

NIE

Code as Law

