## Chapter 7: Regulation

What role can governmental regulation play in helping to provide individuals with opportunities for mutually beneficial cooperation?

### Neoclassical Arguments for Regulation

Neoclassical Welfare Economics support the regulation of markets in a wide variety of cases. Ideally, a competitive market intermediates mutually beneficial transactions between consumers. Insofar as real-life markets deviate from idealized competitive markets, governmental regulation can be justified (on both neoclassical and contractarian grounds).

**Example**: In order to maintain a competitive market, regulation is required...

(1) to deter firms from *colluding* and to prevent *monopolies*.
(2) to prevent firms from taking excessive *risks*.
(3) to correct for *externalities*.

Although the Neoclassical arguments rely on different normative criteria than the Contractarian one, they're based on a common understanding of *how markets work*. And so the Contractarian can support these kind of interventions for the same sort of reasons.

### Choice Overload

Sugden has argued that competitive markets provide consumers with a wealth of opportunities (chapter 6), that a person's interests are better served by by being able to choose from larger rather than smaller opportunity sets, and that most people will recognize that they benefit from larger opportunity sets (chapter 5). But might too much choice be bad?

> *Choice overload* is "when consumers face so many options that the quality of their decisions declines, or they feel dissatisfied with their final choices, or their motivation is so undermined that they avoid choosing altogether."

There is some evidence that a wider range of choices undermines choosers' satisfaction and motivation (e.g., Iyengar & Lepper's jam experiment, 401(k) plans, health insurance). But there is also evidence to the contrary (the success of Wal-Mart and Amazon).

Sugden argues (1) that the canonical examples of choice overload generally differ from typical market choices in two ways: people are much less likely to "know their own preferences", and the options are not organized into relevant categories. But (2) that in a competitive market, consumers typically do know their preferences and commodities will typically be organized into categories.

### Self-Constraint

Do markets tend to provide individuals with opportunities to constrain their later choices? Yes, for those who are willing to pay for them (but they also provide counter-technologies allowing people to escape from from constraints they no longer wish to be bound by); so, also no.

But, if the market cannot genuinely provide these opportunities, first, that is also a problem for the neoclassical approach; second, it's not clear how common preferences for self-constraint really are.

**Obfuscation**

Firms engage in *obfuscation* when they deliberately price their products, or present information about prices, in unnecessarily complex ways. This can increase *search costs*, which tend to reduce the effectiveness of price competition leading to higher prices.

| **Examples of obfuscation** | |
|---|---|
| *Drip pricing* | advertising a low headline price to attract consumers to a firm's store/website, and then adding unexpected price components before checkout. |
| *Baiting* | advertising a low headline price, which are later revealed to be subject to constraints that are difficult to meet. |
| *Price partitioning* | quoting separate prices for component parts of an indivisible offer. |
| *Exploding offers* | offers that will be withdrawn unless immediately accepted. |

There is a strong contractarian case for regulation here because "obfuscation undermines the capacity of a market to intermediate mutually beneficial transactions."

**Fixed Costs and Price Discrimination**

The Market Opportunity Theorems only hold in economies in which production takes place under constant returns to scale. They don't hold if there are increasing returns to scale or if production requires certain minimum quantities of inputs. [The Problem of *Natural Monopoly.*]

> *Strong Interactive Opportunity Criterion (Counterfactual version).* For every group of consumers, for any feasible and non-dominated transaction, *were it to be the case that* all members of the relevant group wanted to participate in it, each member's component *would be* an element of her opportunity set.

Crucial Question: Is the total amount that potential users are willing to pay to use the good greater than the costs of building and maintaining that good?

Problem: If consumers lack integrated preferences, it's not clear that "willingness to pay" is well-defined.

Proposal: Define "willingness to pay" as the maximum revenue that can be got by *price discrimination.* If the maximum revenue that can be generated exceeds the costs of production, there is a jointly feasible and mutually beneficial transaction between potential consumers and the suppliers of the inputs necessary for production.

There is no guarantee that an unregulated market will intermediate these transactions because (1) the discriminatory tariff might not be practically feasible (e.g. we might not be able to identify which individuals are willing to pay which prices) and (2) the fixed costs might make it so that arbitrage profits cannot be easily competed away.

**Public Goods**

A public good is *non-rivalrous* (its costs are independent of the number of people who enjoy its benefits) and *non-excludable* (not possible to allow some to enjoy its benefits will restricting others from doing so).

Regulatory Ideal: public goods should be supplied if and only if the total willingness to pay of beneficiaries exceeds the total cost, and those costs should be apportioned between beneficiaries so that, for each individual separately, willingness to pay exceeds actual payment.
Because public goods are non-excludable, we cannot use price discrimination to measure "willingness to pay". Instead, we can exploit complementarities between public and private goods (e.g., flood protection and property values) by taxing the private good.

**Otto per Mille**
Philosophical objection to willingness-to-pay measures of value in cost-benefit analysis: it implicitly assumes that individuals think of public goods in instrumental terms, and that this assumption is illegitimate. [e.g., Anderson, Sandel, Hausman]

(I don't fully understand this argument, or Sugden's response to it.)

## Chapter 8: Psychological Stability

Principles that are self-reproducing (in that they reproduce a general belief in their fairness and a general willingness to abide by them) are *psychologically stable*. What properties must a market economy have in order for its governing principles to be psychologically stable? (In particular, in order for the principles to be psychologically stable must the "baseline of non-agreement" be acknowledged as fair? Sugden says: No.)

**Task:** Design an economic institution based on principles which, when put into operation, will command continuing general support. (Principles that are psychologically stable.)

*Contractarian Argument.* We can give a contractarian argument for the market only if we can say, to each individual, that it is in their interest to participate in it. This involves appealing to each individual's interest as they *perceive* it. In order for market principles to be psychologically stable, we can only appeal to each individual's interest as they *currently* perceive it. So, we can give a contractarian argument for the market only if we can say to each member, *looking ahead from where she is now*, that she can expect to benefit from participating in the institution.

**Can Everyone Expect to Benefit from the Market?**
In equilibrium, each consumer is able to get whatever he wants and is willing to pay for, when he wants it and is willing to pay for it. Each individual can expect traders to seek out potential transactions that can benefit him together with others, and to make those transactions available.

However, this does not guarantee that one should expect to benefit from participating in the market. New knowledge and changing tastes can change the transactions that others are willing to participate in, leading to losses for some.

Does everyone gain from the prosperity of others? No. Other people's wealth is good for you if they demand what you can supply, or if they can supply what you demand; but other people's wealth can be bad for you if they supply what you supply, or demand what you demand.

Pecuniary externalities redistribute surplus, but there is a systematic tendency for them to benefit the owners of goods that are in fixed supply (and who can gain from increases in rent). Price discrimination (which allows producers to recover fixed costs by tailoring prices to what different consumers are willing to pay) can help make it so that some benefit from the prosperity of others by, e.g., defraying some of the costs of supplying goods to the less prosperous, increasing the supply of public goods. But this still isn't good enough.

*Conclusion:* "neither theoretical reasoning nor empirical observation allows us to be confident that, in the absence of any extraneous redistributive mechanisms, markets can be expected to work to the benefit of everyone who participates in them."

**Underwriting Expectations of Mutual Benefit**

Consider a scheme of *partial social insurance*: at the end of every month, each individual's income will be assessed, and that all income above some threshold will be taxed at some fixed proportionate rate. The proceeds of this tax will then be distributed according to some formula.

The downside to partial social insurance is that it imposes certain restrictions on individuals' opportunities for mutually beneficial transactions. The upside: it allows more individuals to share in the benefits created by the workings of the market (potentially rendering the principles governing the scheme psychologically stable).

*How can the tax be justified to the high earners?* Skills only have the exchange values that they do in the context of an economic institution. If your skills are highly valued in an economic institution, it is in your interest for that institution to remain stable. An institution will remain stable only if it's governed by principles that are psychologically stable (i.e., people believe them to be fair and are willing to abide by them). Those principles are psychologically stable only if each person can expect to continue to benefit from them. The redistributive effects of partial social insurance are necessary to underwrite these expectations of continued benefit. Therefore, it is in the interest of high earners to support the stability of the institution by participating in the social insurance scheme.

*How can the scheme be justified to the low earners?* A market institution with partial social insurance is one that everyone can expect to benefit from. Because of redistributive taxation, low earners will benefit from the prosperity of high earners (relative to the baseline of a market economy without redistributive taxation).

But why is that the appropriate "baseline of non-agreement"? Why would low earners regard the principles governing this institution as fair?