Economics of Regulation

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Department: Economics, Central European University
Semester/term, year: 2016/2017 Spring
Course level (MA, PhD): MA
# Credits (# ECTS Credits): 2(4)
Pre-requisites (if applicable): 1st year course on Microeconomics
Course e-learning site: see Economics Department courses
Office hours: by appointment

Course Description
The course gives an overview of the economic concepts, theoretical and practical approaches used in market regulation. Government interventions into market developments could be warranted because of several welfare-distorting factors, but these policies need to be well understood in order to avoid further market failures. We will concentrate on the regulatory policies and approaches applied in industries where the core of the problem lies in the significant market power of incumbent firms, and so their market behavior needs to be regulated. Most network industries fall into this category (telecommunications, energy, post services, cable TV), and so we will briefly study these industries as well. Social regulation (concerning health, safety, environment) will not be touched in this course, and there are separate courses on competition policy (antitrust), which is the other main form of market-specific policy intervention. The aim of the course is to get acquainted with the basic principles, forms and models of regulations, to understand how economics shapes (or should shape) the various regulatory approaches.

Learning Outcomes
Students are expected to gain the ability to identify market distortions and possible ways to overcome them. They are expected to get more insights and experience on how to discuss regulatory policies in a presentation and written assignment form, both from a theoretical and empirical point of view. They should also be more familiar with some microeconomic tools to model imperfectly competitive markets.

Course Requirements
Assessment
- 50% based on a written exam at the end of term. It will be an "open notes exam": you can bring your notes on paper, but not any printed, photocopied or
electronic materials. The exam will contain some conceptual and theoretical questions and discussion of regulatory approaches. **There will be no specific questions to give microeconomic proofs or to solve computational exercises at the exam,** but you can be asked to link your reasoning to some theoretical results we discussed in class. You can check a previous exam at the e-learning site.

- **25% based on an individual term paper on a selected topic.** See later for more details. Deadline of submission: first Monday after the end of exam period.
- **25% based on a seminar presentation in one of the last two classes.** See later for more details. Depending on class size, presentations can be done by pairs. Deadline of submission of the presentation file: beginning of last class week (exact date to be specified later).
- **Max 5% bonus based on active class participation:** you can still have 100% without this part.

**Audit policy:** you are welcome to take the course for audit. In order to get an audit grade, you need to submit either one of the assignments.

**COURSE SCHEDULE**

**Core course materials to read**

- **The main material is based on selected chapters from Viscusi-Vernon-Harrington: *Economics of Regulation and Antitrust* (2005, referred as VVH).** The core chapters did not change considerably between editions, but the latest recent 4th edition contains more fresh empirical data, plus later chapters on social regulation are more updated.
- For one lecture, I will use materials from Klemperer: *Auctions: Theory and Practice* (2005). It is available online at [http://www.paulklemer.org](http://www.paulklemer.org)
- Lecture slides will be uploaded to the e-learning website before each class. You can already check there the slides from the previous year (although this year I will change the order of topics a little bit).

**Additional useful textbooks (not required reads, but reserved in the library)**

- Sherman: *Market Regulation* (2008). There are lot of overlaps with VVH, but it also contains good materials for regulatory policies not discussed in class.
- Decker: *Modern Economic Regulation* (2015). This is a recent textbook with also European examples, good but tight summaries.
Recommended materials for some topics (not required, reserved in the library)

- Laffont-Tirole: *Competition in Telecommunication* (1999) - mostly on regulatory approaches in telecom, but good presentation of theoretical principles from a practical point of view.
- Berg-Tschirhart: *Natural monopoly regulation: Principles and practice* (1988) - bit old, but this classic still contains one of the best theoretical discussion of basic regulatory methods, although at a more advanced level.

Detailed timeline of the course and core literature

1. Introduction to economic regulation: various forms, objectives, rationale, benefits and costs
   - VVH Chapters 1, 2 and 10
2. The main economics concepts and models behind the economics of regulation
   - VVH Chapter 4
3. The potentially beneficial effects of entry, the role of entry barriers
   - VVH 6
4. The natural monopoly problem and basic forms of second-best regulation. Ramsey-pricing, with examples from postal industries
   - VVH 11 first part
5. Rate-of-return regulation and refinements, peak-load pricing, with examples from electricity markets
   - VVH 12 first part
6. Incentive regulation and asymmetric information
   - VVH 11 remaining parts
7. Price caps, yardstick regulation
   - VVH 12 remaining parts
8. Franchise bidding, with examples from cable television
   - VVH 13
9. Auction design and spectrum allocation in telecommunications
   - Klemperer Chapter 1 (only Section 1 and 4); Chapter 5
10. Access regulation, with examples from telecommunications
    - VVH 15 first part (depth depends on time remaining)
11. Seminar presentations OR entry regulation (examples from transport industries)
    - VVH 16 (only if time allows)
12. Seminar presentations
Seminar presentations
The seminar presentations will be given at the last one or two seminars. Each student (or a pair of students, if lot of people take the class) is expected to identify a specific regulatory policy of a chosen country (but it can be also at the European Union level) and discuss it in a presentation of 15-20 minutes, followed by a short discussion. This is basically the time and format you can expect in public policy.

The choice of topic is completely up to you, but you should consult the subject with me till the start of the week before the last. Do not choose a too wide topic, like "telecom regulation in my country in the last 5 years". Some good examples:

- The recent UMTS spectrum auction in 201x in country X: auction design and final outcome
- Main changes in the energy rate-of-return regulation at the start of 201x by the Energy Regulator in country X
- Experience after entry-incentivizing policy steps in the postal sector made in 201x in country X
- Recent issues on the regulation of airport access at the European level

In some rare cases - for example, if a student already writes on that specific topic -, I will ask you to choose another topic, so consult me on the topic after a few hours of research.

Guidelines on the presentation

- A short policy presentation of this kind should be very straight to the point. You cannot really have more than 12 slides (preferably less) and you should convey a brief but consistent message.
- You should briefly introduce the market context in which the specific regulation takes place: how many firms with how large shares, what kind of tools are available for the regulator, etc.
- You should clearly identify the (expected) market failure that the regulator wants to correct and the regulatory approach taken (link it to materials covered in class).
- Discuss briefly the main elements of the regulatory mechanism, its potential benefits and pitfalls, preferably backing it with some numbers or ex-post experience.
- **You are encouraged to give your own opinion. Even if it is not completely correct, it is usually more appreciated if the presenter commits to its own views (in real policy work, you should do it almost all the time).**
- At the last slide you should correctly refer to the sources used (but don't present it). You do not need to use lot of sources, but try to use original documents (like materials at the regulator's website) Newspaper, weekly economic journal articles or consulting firms' presentations are also fine. Your sources should not necessarily be in English.
In my grading (and also in policy debates), big weights will be given on the introductory and concluding message / slides plus internal consistency, so do not be sloppy at these parts.

**Term paper**

This project is about writing a summarizing paper of 5-8 pages on a chosen topic in regulation not covered in class, based on one paper or textbook chapter. If you really want, you can consult multiple sources, but for this assignment there is no problem if you concentrate on just one.

The situation you want to imagine is that you should prepare a summary brief on a specific regulatory policy to a policy maker who is not a specialist in the subject, nor is he a trained economist but can understand economic principles, simple graphs or numbers if presented intuitively.

You can choose any chapter from the VVH book after Chapter 15 that is not covered in class (like patent regulation), a chapter from the Sherman book with a topic not covered (for example consumer protection) or any chapter from the recommended readings. If the chapter is long and covering several issues, you can settle for one part (like airport regulation from a chapter on transport regulation). If you read a good academic article on a specific regulation or a brief paper from an economic consulting firm discussing some regulatory steps, you can go for that too (but try to pick one that is not outrageously one-sided). Do not worry here if the examples are more US-based or on a more developed country. Please consult with me on the topic, just to make sure there are no overlaps between papers.

**Guidelines on the paper**

- A good policy paper has an abstract of 2-4 sentences and one (or at most 2-3) well-defined questions to examine. So you should have it too.
- From the Introduction, the reader should clearly get 1) what you do, 2) what is the result, and 3) what is the policy consequence, why is this useful / important.
- You should clearly identify the (expected) market failure that the regulator wants to correct.
- Discuss briefly the main elements of the regulatory mechanism(s), its potential benefits and pitfalls, preferably backing it with some numbers or ex-post experience.
- If you find / prepare one or at most two good summarizing table or graph, that helps considerably to sell your point.
- You are encouraged to give your own opinion briefly at the end.
- You should correctly refer to the sources used, now play attention to the exact places of the paper / chapter (so for example if you take or modify Table 13 at page 343, you should correctly note it).