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The Deregulation of Industry:  
How Far Should We Go?  

WESLEY J. LIEBELER*

We have been asked to address the question of the extent to which the government should get out of the business of "regulating" private firms. More specifically, we have been told that we need a theory, if substantial deregulation is to occur, to tell us when and to what extent such deregulation should take place. We have also been asked to ponder whether or not that is the same question as what justifies regulation in the first place, i.e., does the fact that there is an existing system of regulation in place in any particular industry pose distinct problems?

I propose that we apply to the first two of these questions the techniques of zero-base budgeting, a system which appears to be coming into increasing use among private firms. It requires managers to justify all future expenditures on the assumption that all of their existing programs are nonexistent. It is probably not very popular among those who are required to respond to its demands for it requires more than the pleasures of justifying an expansion of our empires. It actually purports to require us to justify our existing empires.

In applying a zero-base budget approach to various schemes of government regulation we ask, first, why do we have this regulation at all? The clear implication of this approach is that the regulation will be halted, no funds will be forthcoming for its continued operation, unless it can be "justified" in some way.

The concept of justification implies a standard of measurement. In the private firm that standard is, presumably at least, contribution to profit. This is another way of saying, it is worth noting, that the firm is able to sell the output of the particular operation being considered to others who are willing to pay more than (or at least as much as) it costs to produce the output in question.

Thus, the justification of private investment is based ultimately on the willingness of others to give up part of their wealth in, for the

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most part uncoerced, market transactions in exchange for the output in question.

This is a profoundly legitimizing justification—one that depends on the more or less continuing assent of the parties to the transaction. We can get stung, of course, and sometimes we do. We are not, however, as a general proposition, required to come back for more.

In a very gross way similar considerations are sometimes involved in our relationships with the state, as those "governing" the City of New York have the opportunity to learn. They are involved only grossly, however, and their effects diminish sharply as the scope of the governmental unit involved increases. The transaction costs of leaving the United States for more congenial atmospheres, for example, are high indeed. They are so high that for present purposes at any rate, we may safely ignore the direct effect of market forces on government behavior.

It is becoming increasingly recognized, however, that market analysis does provide a powerful tool in judging when government activity may be appropriate. While it may be less recognized, it is also true that market analysis can contribute greatly to the next question: What kind of government activity is best suited to solve the problem which we have concluded is of such nature and magnitude as to justify government intervention in the first place?

The market analysis approach to judging the necessity and/or form of government activity is based on the proposition that the well-being of consumers is highest in the context of an effectively operating free market. The efficiency of the market is a proposition that is generally accepted among economists and on which very large parts (if not most) of American public policy is based. This wide regard for the efficacy of markets is attested by the fact that even the most ill-conceived government programs are justified (or accompanied) by claims that in any particular area the market, left to itself, simply cannot handle the problem.

A significant number of such claims are window dressing. It is true, nonetheless, that there are times when the market, for various reasons, does not do very well. It is becoming popular to refer to those situations in which the market does not do very well as cases of market failure.²

¹ At this point the issues of fraud, misrepresentation, etc., are omitted.

² Professor Coase has used the concept of "market failure" to explain why firms come into existence, i.e., why all transactions are not conducted in the market. Coase, The Nature of the Firm, in Readings in Price Theory 334 (Stigler and Bouldings eds.
There are lots of problems with the term "market failure." Perhaps it should not be used at all. It has a quality about it that will, I predict, captivate lawyers and other public policy types. Its lack of precise meaning may make it as popular as "barriers to entry" and other similar terms that serve as substitutes for thought in the antitrust field. I shall, however, use it as a general expression which must be made more specific before it can be regarded as operational in particular instances.

During the past year the Office of Policy Planning at the FTC has attempted to utilize the concept of market failure in evaluating the work of the Bureau of Consumer Protection. The Planning Office has developed a series of questions in this regard that may be relevant to broader issues of government regulation than those involved in the work of the Bureau of Consumer Protection. More specifically, I believe those questions may be useful in providing a structure within which to analyze the utility of government regulation in general.

These questions, as developed for use within the FTC, are:

1. Has the market failed to operate as regards the matter at hand?
2. If it is claimed that it has, in what respects has it failed and what are the reasons for such alleged failure?
3. Are the remedies proposed addressed to the respects in which the market has been alleged to have failed?
4. What is the likelihood that the proposed remedies will correct the specified failures of the market so as to improve consumer welfare?
5. What are the approximate dollar benefits in terms of improved consumer welfare that might reasonably be expected to flow from the proposed remedies?
6. What are the costs involved in implementing the proposed remedies?

These questions are not very interesting unless we can say something specific about the nature of "market failure." Perhaps the most commonly accepted approach to the question is in terms of transaction costs. To say that market failure exists is simply to say that the costs of conducting particular kinds of transactions across markets exceeds the gains realizable from those transactions. Those costs may be reduced by organizing the transactions within a firm or, possibly, through the involvement of the government. See Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (1975); Williamson, The Economics of Antitrust: Transaction Cost Considerations, 122 U. Pa. L. Rev. 1439 (1974); Williamson, The Vertical Integration of Production: Market Failure Considerations, 61 Am. Econ. Rev. 112 (May 1971); Liebeler, Integration and Competition, in Vertical Integration in the Oil Industry 5 (Mitchell ed. 1976).
costs. The transaction cost approach has interesting implications in terms of property rights theory, which is also an important consideration in thinking about the appropriateness of various kinds of government activity, or the appropriateness of any kind of government activity in the particular circumstances under consideration. It is in fact quite useful to think of property rights as a device for reducing transaction costs, or for providing a means of internalizing the costs and benefits of market transactions.³

It may be useful to go through the questions that I have listed above and substitute the ideas of external costs and benefits wherever market failure is mentioned. Or we might substitute the notion of "high" transaction costs, which is the basic reason for the existence of externalities in the first place. In the absence of "high" transaction costs, parties related to each other in the production and consumption of external costs and benefits would find it profitable to engage in market transactions that would bring such externalities to an end.⁴

If such externalities did not exist to any significant degree, it is hard to imagine any justification whatever for direct government regulation, or even for most indirect forms of government regulation. If it is the presence of significant externalities that justifies collective action (government intervention), then it seems to follow that the purpose, and thereby the structure or nature, of government regulation, is to get rid of the externalities, i.e., to bring about, in so far as possible, that state of affairs which would exist but for the externalities. That state of affairs, of course, is that which would exist if persons were able to enter into exchange transactions without being constrained by these supposedly intractible transaction costs. That state of affairs, obviously, is the one which would exist in a zero-transaction-cost market. And in this conclusion lies the justification for my previous claim that market analysis provides a powerful tool for judging the question of when government action may be appropriate and, when we conclude that it is appropriate, for judging the question of what kind of government action is best suited to the end at hand.

Under this formulation, I would suggest that government action is appropriate when the gains it may realistically be expected to produce, in terms of increasing the well-being of persons who would engage in exchange transactions but for the presence of transaction costs that exceed the value to be obtained from such exchanges, are greater than

the costs attendant upon such government action. This formulation (my third question) also suggests that government action should be aimed at reducing transaction costs, i.e., at facilitating exchanges. If this is true, serious questions are raised about the appropriateness of government regulation which prevents exchanges, as much, if not most of existing regulation does.

Let me develop these ideas more specifically in the context of the regulation of prescription drugs by the FDA and in the context of the activities of the FCC. I will then have some comments on the third question which we have been asked to address: Does the fact that there is an existing system of regulation in place change any of the basic issues?

To apply the approach which I have suggested to the prescription drug market, by analogy to the zero-based budget system, I assume the total absence of FDA regulation. It is difficult to apply my first question: “Has the marked failed to operate as regards the matter at hand?” in quite those terms because the market at hand has been the subject of pervasive government regulation for such a long period of time. I will modify my first question slightly and ask, instead, whether there is anything about this market that we could expect to cause market failure in the absence of FDA-type regulation.

In answering this question, which we have noted translates readily into a search for significant externalities, it will be useful to refer to some recent developments in the field of information theory. Important contributions have been made by Philip Nelson of the State University of New York and, of more particular interest to the present discussion, by Michael Darby of UCLA.

Their work suggests the existence of three different qualities in goods or services, defined primarily in terms of the most cost effective ways in which consumers can obtain information about those qualities. These three different qualities are:

(1) **Search qualities**, those the salient characteristics of which can be ascertained by search or observation prior to the time of purchase. Examples would include the style of a dress, the ripeness of a banana, or the price of either.

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5 This formulation assumes that the government action being considered does not impose external costs on others, an assumption that may be dubious in some cases.


7 See Darby & Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J. Law Econ. 67 (1973).
(2) **Experience qualities**, as to which experience or trial is the most effective source of information. Examples would include the taste of a can of tuna fish or a can of beer, the efficacy of a particular laundry detergent, an underarm deodorant, or the like.

(3) **Credence qualities**, as to which reasonably well-informed judgments cannot be made, either before or after purchase, without obtaining additional costly information. Automobile, television, and human body repair are examples. Darby suggests, as an example of a credence quality, the claimed advantages of the removal of an appendix, which will be correct or not according to whether the organ is diseased. The purchaser, however, will have no different experience after the operation no matter what the condition of his appendix might have been.

Prescription drugs are heavily laden with credence qualities, so much so that we may refer to them simply as credence goods. We are not able to learn much of importance by looking at them, for example, nor are we willing to respond with alacrity to the imprecation “Try it, you’ll like it.” In order to make intelligent decisions as to the use of prescription drugs, both consumers and prescribers need to have additional information which is not free. But since such information is not free, we go on to ask what would be, given the absence of FDA regulation, a likely source of such information?

A firm or firms could arise in the market to produce and sell this type of information. We do not observe much of this, however, largely, it is argued, because of the form of market failure that is associated with the high transaction costs involved in policing the use of whatever information our hypothetical firm may produce. The first purchaser of such information can pass it on to others without reducing its

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8 If such information were free, there would obviously be no need for FDA-type or other government regulation of this market. Each consumer (or prescriber) could compare the available information with his own (or his patient’s) utility function and make the correct (optimal) decision each time. This is simply the other side of the coin that government intervention is justified by a comparison of its costs and benefits in the context of clearly identified market failure (here high transaction costs).

9 The above formulation implies that FDA regulation is a way of providing information. It is that, of course. This may be seen most clearly in those cases in which FDA has approved a drug for one use but not another. The drug is now available in the market for the first, approved use. As a result, the most obviously coercive form of FDA activity, keeping a drug off the market, is not present. But even though the drug is physically available at the corner drug store, I suspect that not much of it will be used for the unapproved purpose. If that is in fact the case, one reason may be the implicit information carried in the fact of nonapproval for that use by FDA.

But FDA regulation is more than a way of providing information. The power to keep drugs off the market includes the power to prevent advantageous exchanges that would otherwise be made, even in the absence of anything like perfect information, between buyers and sellers of drugs.
value to himself. This makes it extremely difficult for the producer of information to recover the costs of its production. If those costs cannot be recovered, the information will not be produced. These considerations explain why most information about products is supplied by the makers of these products. They are able to recover the cost of creating and supplying this information in the price of the product to which that information relates.¹⁰

This “tying” arrangement enables the manufacturer to internalize the benefits of the information and thereby insures its continued production. But it also skews the incentives to produce accurate and truthful information, particularly where, as in the case of credence goods, consumers have great difficulty in evaluating those characteristics. In short, the maker of the product may have an incentive to provide only that information that will help to sell the product, even if it is not accurate, true, or complete.

Let us now go back to the first question as modified to fit this market: Is there anything about the prescription drug market that we could expect to cause market failure in the absence of FDA-type regulation? The discussion suggests that to the extent that it is not possible (i.e., very costly) to internalize the benefits of producing information as to credence qualities so as to recover the costs of its production without badly skewing the incentives to accuracy and truthfulness, we may conclude that we are hot on the trail of something that might be called a market failure.

The chase is not over yet, however. Private action may still be equal to the event. And if it is not, satisfactory results may be obtained without getting into direct government regulation at all, such as through appropriate doctrines of tort law.

The private reaction to “market failure” of the type I have described above is integration of some kind, i.e., the formation of a firm either through ownership arrangements or by contract. If X, or X and a group of like drug consumers, were vertically integrated into drug production, I suspect that they could solve the problems outlined above in short order. They would issue instructions to the management of their manufacturing subsidiary to produce the kind and amount of information that the owner/consumers wanted and they would fire them if they failed to heed those advices.

¹⁰ Liebeler, Integration and Competition, in Vertical Integration in the Oil Industry 5, 10 (Mitchell ed. 1976).
Of course, we need not actually integrate into the production of drugs. It is, after all, information that we are after. A horizontal integration (a co-operative) of drug consumers could be formed to pay drug manufacturers to produce this information, which would then be shared among the members of the co-operative. The transaction costs of such organization are surely not insurmountable. In fact, we are told by no less a personage than J.K. Galbraith, albeit at a time when he at least purported to write about the subject of economics, that co-operative organization is an important aspect of economic life in some parts of the world. It surely is not in the United States, a fact which suggests that at least some information is produced in other ways, thereby reducing the benefits to be obtained from consumer integration into the information market to a point below the cost of doing so.

FDA regulation itself is certainly one factor in this information production system. Most of us know that the agency is out there doing something, apparently keeping drugs off the market that would be available under more benign conditions. This piece of information, along with the standards of efficacy and safety which are used as a basis for approving drugs, certainly reduces the gains available from the private production of information. The problem, of course, is that the FDA system of regulation imposes substantial costs of a different sort.

Another source of information is the reputation of the manufacturer and the more detailed information on particular drug use and side-effects provided by particular manufacturers, the value of which is based in large part on that reputation. If consumers placed a high value on (i.e., were willing to pay for) complete, accurate, and truthful information on prescription drugs, we would expect to find firms attempting to respond to this demand.

This response would entail the construction of reputations for the desired characteristics. The construction of these reputations by firms should be regarded as a form of forward vertical integration into

11 J. GALBRAITH, AMERICAN CAPITALISM 125 (1950).
18 The FDA’s efforts to keep Laetrile off the domestic market as a cancer treatment are classic in this respect. It is attempting to prevent the importation of the drug from Mexico by patients who have been advised of all known relevant facts by their physicians. See Los Angeles Times, Jan. 9, 1976, at 32; Liebeler, Critique of Crout, New Drug Regulation and its Impact on Innovation, in IMPACT OF PUBLIC POLICY ON DRUG INNOVATION AND PRICING 267 (Mitchell & Link eds. 1976).
information supply and, as such, a substitute for backward vertical integration by consumers, the absence of which we have noted.\textsuperscript{14}

In estimating the reliability of information supplied in this way by manufacturers, we note that the construction of good reputation is a costly business; the destruction of such a reputation comes much easier. Because of the costly nature of good reputations, they will probably not be readily frittered away through the provisions of information that does not accord with that which one would expect based on the reputation. As to manufacturers with these highly developed, costly reputations, it may well be that my previous conclusion that the maker of a product has an incentive to provide only that information that will help sell the product, even if it is not accurate, truthful or complete, does not hold.\textsuperscript{15}

All of this goes to the question of whether or not the market really has "failed." It may very well not have; the gains available from government involvement may not exceed the costs. The question of whether and when markets have "failed" in particular cases is a question on which persons, at least one of whom is reasonable, can and surely will disagree. I am not particularly interested right now in whether or not the prescription drug market would "really" fail absent FDA-type regulation. I am interested in outlining an approach to, and a way of thinking about, the question of when government regulation may make sense and, when we conclude that it does, what kind is best suited to solve the problem at hand.

So let us assume for purposes of discussion that we have identified a case of significant market failure, and let us pass over the question of whether or not it could effectively be treated by modifications in the law of torts or in other indirect ways. That brings us to our third question, to which the immediately preceding discussion also relates. That question, modified slightly to fit into our discussion of the drug market, is: What remedy (or regulation) is most appropriately addressed to the respects in which we have concluded (here assumed) that the market has failed?

The answer to this question is, obviously and happily, a direct function of the market failure that we have identified or assumed. The\textsuperscript{14} See Liebeler, Integration and Competition, \textit{supra} note 2.\textsuperscript{15} Or it may be that such firms are selling a different product than that which is being sold by their less highly regarded fellows. They may be selling drugs plus information, which in the hands of consumers gives the drugs a higher value than the perhaps similar (or identical) drugs being produced by firms which have not developed such a subsubstantial reputation for goodness.
most appropriate regulation is that which will most effectively deal with our market failure.

Since the market failure assumed in this case involves the unavailability of appropriate information, government intervention should be designed to facilitate (or provide for) the delivery of such information. This could, of course, be done indirectly, for example by altering the "duties" of manufacturers under tort law. But we have resolved to pass this issue for the moment.

It could also be done directly. The government could become a collector, distributor, and, if absolutely necessary, a producer of information. It could, for example, report the results of any tests which had been performed, either in the United States or elsewhere, regarding any particular drug, experience with the drug during use in other countries and, of particular importance, user experience in the United States, with particular attention being paid to adverse reactions, if any.

If information such as this is readily available to doctors and to their patients why will they not be able to make decisions as to drug use that are appropriate to their own notions of their own good? I think that they would be able to do so, but I can appreciate the fact that not everyone will agree with me—immediately. When I outlined these ideas the other day at a conference on drug regulation, a well-known former general counsel for FDA told me that while it was an elegant scheme, it simply would not work. In anticipation of the possibility that others may be similarly guided, let me comment briefly on the reasons why they would be wrong.

It will no doubt be objected that information of the type that I have described will be voluminous, highly technical, and unintelligible to all patients and to most doctors. It may also be put that I can not expect patients (or doctors) to read what amounts to a prospectus before consenting to, or prescribing, a penicillin injection or some similar treatment. I think that both propositions are undoubtedly correct.

They are also not very interesting and imply a rather naive view of how information travels. What doctor (or patient) now cares whether or not penicillin was ever approved by the FDA, or that it may have been approved under less rigorous standards than are applicable now? Not very many, I would venture to guess. For the word "penicillin", or perhaps some brand name therefore associated with a particular manufacturer, carries a message that is equal to most events. Why? Because

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16 Liebeler, supra note 13, at 269-70.
of the reputation that the drug has built up, a reputation based on countless experiences that both doctors and patients have had with it.

The same thing would be true of many, if not most or all, other drugs that are currently in use in this country. As to them the burden of informing oneself should not be any greater if FDA were to disappear this afternoon. The real differences between the information system that I have proposed and the present system would occur at the point where new drugs either come onto the market or they do not, and with regard to those drugs that have not been in widespread use long enough to have provided complete information on adverse reactions, and to have gained reputations as to their efficacy and adverse reaction creating potential.

As to these two points of significance, it is not clear that a system which emphasizes the collection and dissemination of relevant information and which permits fully informed doctors and patients to assume the risks of using these newer drugs is inferior to the existing system, which does not collect and handle information very well and which prevents the exercise of such informed individual choice. It is not, to put it mildly, clear at all.

But this gets us into an estimate of the costs and benefits and the effectiveness of various proposed schemes of regulation or non-regulation. These are the subjects addressed by questions 4-6. While they are of great importance, they are obviously beyond the scope of the present discussion. Suffice it to say that the present system costs plenty in terms of governmental and private resources required for its continued operation. And that expenditure, at least on the basis of the work done by Peltzman and Wardell, is producing negative benefits for our society.17 Such a system, like a great deal of current government regulation, has little to recommend it.

The FCC presents a much simpler problem. The invention of radio and later of television created a new resource of great value but in which no rights of private property had ever been developed.18 The Federal Radio Commission and later the FCC did develop a system of property rights in the new resource, but they have never become fully private. These property rights, i.e., the “authority” to broadcast during certain times at certain strengths and frequencies, are subject to periodic renewal and can in effect be taken (or continued use by a particular party forbidden) by the government. Just as the FCC “created” these

property rights, it also in effect protects them from encroachment by others by policing the use of the authority which it has granted to other broadcasters, and by preventing broadcasting without authority.

It seems clear that we had a case of market failure prior to the time the FCC created the present licensing system. Just as with the beavers in Demsetz's study of the development of property rights among the Indians,\(^\text{19}\) there was no incentive to build up a clientele on any particular frequency because the policing costs of preventing others from free-riding on that effort were very high. That market failure, however, could readily be cured by developing a system of property rights in radio and television frequencies and authorizing the common-law court system to enforce such rights. The creation of such a system of enforceable property rights would reduce the transaction costs of policing to quite manageable levels and, at least on the surface of things, do away with the need for further or more direct government intervention.

We all know that it was not done this way. Instead we have the FCC. Let us suppose, however, that all of the presently outstanding operating rights were auctioned to the highest bidders or simply given to their present holders in fee and federal courts were authorized to enjoin any interference with and otherwise to protect such property rights.\(^\text{20}\) Let us now apply the zero-base budget technique to the FCC and ask what other functions it performs that could be offered in justification of its continued existence.

It does not regulate the telephone companies with any great distinction. It does, it is said, greatly inhibit the development of cable television systems, much to the benefit of the existing networks, but of more dubious value to society as a whole. It may be that I am missing something of value in its work. But in the absence of such a showing, I see no reason why existing operating rights should not be transformed into private property rights in some appropriate way and the employees of the FCC be invited to engage in more socially useful activities.

As I have said, this is not a new idea. It has been rather extensively treated by others. And yet, to my knowledge, it has not recommended itself even to those benighted apologists of the market system who have found refuge in the current administration. Why not?

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This brings me to the final question: Does the fact that there is an existing scheme of regulation in existence pose problems distinct from those involved in the question of whether or not to institute regulation in the first place? I think the answer to this question depends on whether we are talking about efficiency considerations, as in this discussion, or whether our concern is with equity or income distribution questions. While the latter are certainly important from a political standpoint, they do not raise any interesting theoretical questions and from the point of view of society as a whole, they ought not to be regarded as important even from a political point of view.

The problem is, however, that many regulatory schemes have redistributed income, usually away from consumers into the hands of groups of producers. In at least some cases the benefited producers have competed away these golden eggs, apparently because of the great difficulty involved in effectively colluding even with the help of the government. In the airline industry, for example, this competition has taken the form of more frequent flights, which in turn requires more airplanes than would be required if there were an immediate return to an open market system, or at least it is so argued. A lot of these “excess” airplanes are not paid for; they are owned, directly or indirectly, by a lot of big banks.

I do not wish to modify, or even to hear about, your big-bank-sympathy quotient. I am saying that the existence of particular regulatory schemes may raise problems that at least appear to be different from those raised by the question of whether or not to start down this road in the first place. There may well be short term dislocations. These will probably worsen in proportion to the extent to which the particular regulatory scheme has moved resources away from their most valuable uses. For this reason, these regulatory schemes should be the first to go.

Economic analysis tells us that we could pay all the short-term (private) “losses” that would result from these dislocations out of the efficiency gains from deregulation and have a good bit left over. One of the real challenges of the deregulation effort is to figure out sensible institutional arrangements to do this (assuming that you are not willing to let the chips fall where they may as a result of total and instant deregulation, which is by no means an obvious proposition). I believe that it is fear of these possible short-term dislocations, as well as political opposition from those who would be likely to suffer private losses, that

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leads to regulatory "reform" rather than to outright abolition of agencies such as ICC, CAB, FCC (and for the sake of provoking an interesting discussion, FPC as well), all of which richly deserve that fate. But for many reasons, I do not have great hope for the success of "reform" in this area. I suspect that we would all be better off if we opted for instant deregulation and either let the chips fall where they may or figured out some way to payoff those who would be seriously injured by the short-term adjustments that would be involved. But therein lies the subject of another discussion.