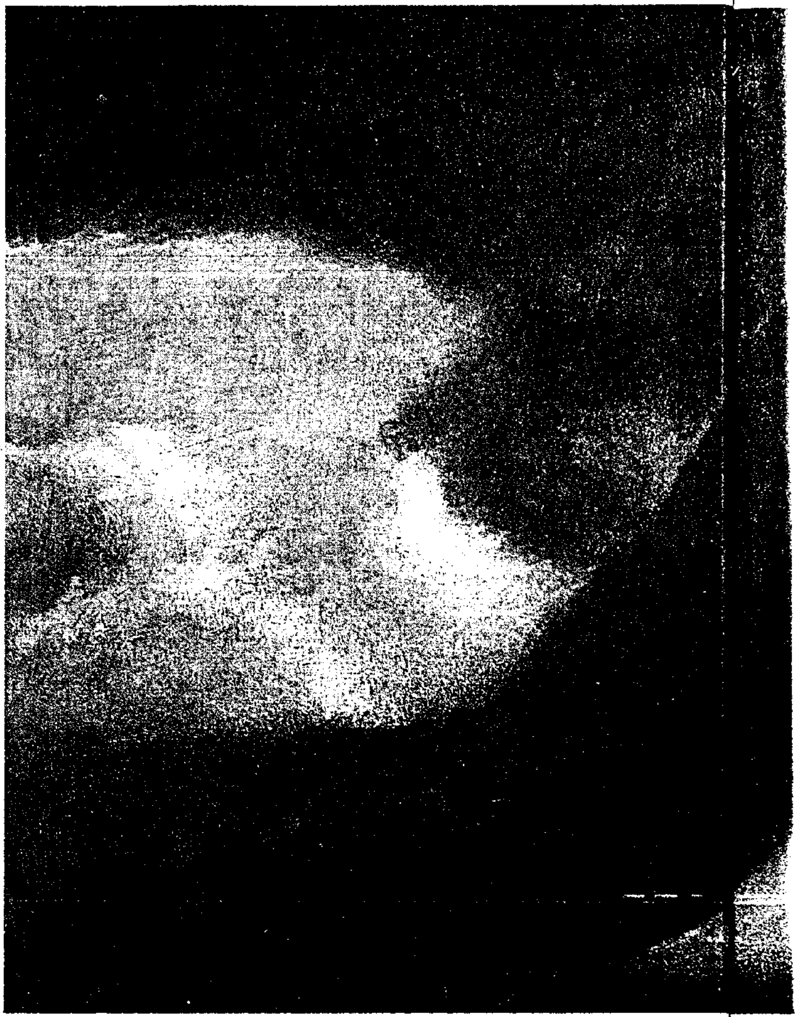
EVERYTHING FOR

BY ROBERT KUTTNER

Deregulation is taking hold across the economy. But in an adaptation from his new book, Everything for Sale, *BUSINESS WEEK columnist Robert Kuttner argues that market forces by themselves are insufficient. Kuttner explains how a mixed economy, combining competition with some form of government oversight, works better than a pure market economy:*



Item: The 1996 Telecommunications Act has just celebrated its first birthday. Consumers and businesses are gradually getting a choice of local as well as long-distance phone companies. But to achieve competition, the Federal Communications Commission (FCC) is more involved in the process than ever.

Item: Market forces have been reducing health-care inflation. But 12 states have passed laws to safeguard the rights of patients and to limit the secret financial incentives that insurance plans give doctors. The federal government has just issued regulations limiting what health-maintenance organizations can do to pare costs and barring insurers from denying coverage to people with preexisting medical conditions.

Item: Electric-utility customers are slowly getting a choice of power company. Six states, led by California, have mandated full competition for electric-power generation. Congress has required that local utilities let independent power producers onto the local grid. But the agencies that regulated the industry aren't going away. Instead, they are finding a new role setting ground rules and directing traffic.

So there is a paradox: If anything, greater reliance on market forces in imperfectly competitive industries turns out to require more of a regulatory presence, not less. Indeed, the Republican radicals of the 1994 Gingrich class, after initially thinking that the regulatory agencies might just be abolished, pulled back.

WAY STATION? This turn of events was less the result of a tactical move to the political center than an acknowledgment of how these industries actually work. As Republican conservatives got down to the business of studying how to bring about greater consumer choice, total deregulation proved impractical. Instead of abolishing the FCC, the Republican leadership in Congress brought forth a bill that mandated greater competition while putting the FCC in charge of assuring fair play. It will probably pursue roughly the same approach when Congress takes up legislation for further deregulating electric power and financial services.

Some free-market theorists, such as Peter Huber of the Manhattan Institute for Policy Research, argue that the lingering regulatory involvement is just a way station on the road to complete deregulation. Eventually, they say, there will be a giant free-for-all to provide information services, entertainment, electric power, and financial services to business and consumers. Regulators need only get out of the way and let competition do the job.

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But this view is turning out to be a mirage. New technology certainly allows for greater competition and consumer choice in industries once regulated as natural monopolies. But much to the disappointment of the purists, this is not an era of simple deregulation, but of regulated competition. Here are the reasons:

■ *Public Purposes.* Industries such as telecommunications, electric power, and health care retain public purposes that free-market forces cannot achieve. For example, as a society we remain committed to universal access for certain goods. Left to its own devices, the free market might decide that delivering electricity and phone service to rural areas and poor city neighborhoods is not profitable, just as the private market brands cancer patients "uninsurable."

Once public policy requires that power companies serve all customers, there needs to be some kind of cross-subsidy scheme to pool the cost. Likewise, when private competition

SALE In principle, yes. But the unseen hand of market forces needs some reining in

in the health-insurance industry tries to maximize profits by denying coverage to people likely to get sick, it defeats the whole point of insurance and requires regulatory intervention.

■ *Unsovereign Consumers.* In ordinary markets, the buyer holds the seller accountable: If you don't like the product, you take your business somewhere else. But this discipline does not work if you have a preexisting medical condition, or if there's only one local cable-TV company, or if there is only one dominant airline serving your local hub.

■ *Economies of Scale.* It may be efficient to let competition sort out who makes the best cheeseburger. But it would not be efficient to string multiple power lines to the home. The local electricity grid remains a kind of public utility, even if there is competition to generate power. Despite new technologies, scale economies are still a reality in many industries. In such industries, the alternative to public regulation is a private monopoly or cartel—which isn't efficient either.

■ *Monopoly.* The entire history of greater competition and choice in telephone service has been a creature of regulatory policy. In order for such companies as MCI Communication Corp. and Sprint Corp. to gain a foothold in long-distance service, it was necessary to restrain AT&T's monopoly power, first through a consent decree and then through ongoing oversight by the FCC. Now, the same process will occur in local service, where there is an incumbent Baby Bell that enjoys the market power to crush upstarts if left free to do so. The FCC has identified no fewer than 266 requirements for achieving fair access.

■ *Systemic Risk.* This is the year when Congress may finally repeal the Depression-era Glass-Steagall Act and allow the creation of an integrated financial-services industry. But the risks of a financial meltdown are so great that virtually all parties to the debate concede that even if we permit new financial conglomerates, banks still need to be regulated as banks, brokers as brokers, underwriters as underwriters, and insurers as insurers. Cathy E. Minehan, president of the Federal Reserve Bank of Boston, observed in a recent speech that "regulatory oversight becomes more difficult rather than simpler as deregulation occurs." With greater competition, she observed, the key task of regulators is to prevent systemic risk.

■ *Externalities.* The normal course of production can create "externalities" that negatively affect society. For example, a generating plant may emit pollutants that cause health problems for surrounding communities. In general, markets have a tough time handling externalities by themselves. In the 1970s, economists such as Charles L. Schultze, chairman of President Carter's Council of Economic Advisers, began urging that "command-and-control" regulation be replaced with more "marketlike" incentive regulation. The idea, in Schultze's arresting phrase, was to harness "the public use of private purposes," by creating economic incentives for businesses to do the right thing.

In the control of pollution, one epic example is the case of tradable pollution permits—an idea long advocated by economists and finally enacted as part of the 1990 Clean Air Act to control acid rain. Congress set a ceiling on the total national emission of sulfur dioxide and then created a market in entitlements to pollute. Polluting industries could either invest in new technologies or buy the certificates. The market set the price. The system has proved to be an ingenious use of incentives, but this was not a market that existed in nature. It required the regulatory determination of a safe level of sulfur-dioxide emissions, as well as a regulatory creation of a new kind of property right.

Are there any cases where full deregulation works? Deregulation has proved successful in some industries, such as natural gas and trucking. But far more prominent are industries such as airlines and the savings and loan business, where deregulation had far less desirable consequences.

Take the airline industry. Airlines today are far more concentrated than before Carter signed the bill abolishing the Civil Aeronautics Board. The fathers of deregulation, such as Alfred E. Kahn, assumed a new era of greater competition, but most hubs became dominated by one or two carriers. Selective price cutting by dominant airlines put most upstart competitors out of business, either via bankruptcy or merger.

True, average ticket prices have fallen, but adjusting for

ILLUSTRATION BY BRAD HOLLAND

fuel costs, they actually fell at a faster rate before deregulation. And instead of prices reflecting the true cost, the airlines have designed a crazy quilt of fares to extract maximum profit. Unlike the telecoms, airlines had no regulatory agency to monitor the experiment and mandate course corrections.

Even the vaunted auction of broadcast spectrum, hailed as the epitome of market principles, required dozens of prior regulatory determinations. Before auctions could proceed, the FCC had to determine which parts of the spectrum should be redirected to what new uses, whether the rights were being sold for a finite period or in perpetuity, how the auction would be conducted, how many competitors were sustainable in each market area, whether licenses could be freely traded in a secondary market, and a host of other ground rules. The answers were not self-evident from pure market principles. Although this used a marketlike mechanism, it was emphatically a contrived market.

HALF A LOAF. Not surprisingly, advocates of pure deregulation are dismayed by the turn toward regulated competition. A recent issue of the journal *Regulation*, published by the libertarian Cato Institute, carries an article bitterly attacking the 1996 Telecommunications Act: "Rather than diminishing the government's role in directing the telecommunications industry, the bill has increased it." Such critics are indignant that the FCC will continue to enforce rules of fair competition. But the alternative would not be a free market but a series of private cartels. Cato has also attacked regulated competition of electricity, as half a loaf.

Alas, for the purists, such sectors as electric power, health care, financial services, and pollution control display variations on the same theme of regulated competition. What these industries have in common is a departure from the perfect market of the economics textbook. Either they have elements of natural monopoly, lingering pockets of market power, positive or negative spillovers not reflected in market pricing, or public policy goals such as universal service or public health, which entail cross-subsidy. All can benefit from greater injection of market principles, but these contrived markets, paradoxically, require smart, discerning regulation.

So regulation is dead: Long live regulation. But the champions of the market should take heart. The new brand of regulation displays a new appreciation for the power of prices and of incentives. It indeed harnesses market principles for public as well as private purposes—but also recognizes that such markets do not exist in nature. □

ERIC SWANSON