INCENTIVE REGULATION AND THE REGULATION OF INCENTIVES

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by
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SPRINGER SCIENCE+BUSINESS MEDIA, LLC

Library of Congress Cataloging-in-Publication Data
Blackmon, B. Glenn.
Incentive regulation and the regulation of incentives / by Glenn Blackmon.
p. cm. -- (Topics in regulatory economics and policy : [17])
Includes bibliographical references and index.
ISBN 978-1-4613-6165-7 ISBN 978-1-4615-2706-0 (eBook)
DOI 10.1007/978-1-4615-2706-0
1. Public utilities--United States. 2. Public utilities--Law and legislation--United States. 3. Tax incentives--United States.
I. Title. II. Series.
HD2766.B545 1994
363.6'0973--dc20 94-18160
CIP

Originally published by Kluwer Academic Publishers in 1994
Softcover reprint of the hardcover 1st edition 1994

Printed on acid-free paper.

To my parents, and their parents

CONTENTS

FOREWORD

The classis theory of price regulation assumed that the regulator knows the firm's costs, the key piece of information that enables regulators to pressure firms to choose appropriate behaviors. The "regulatory problem" was reduced to a mere pricing problem: the regulator's goal was to align price with marginal cost, subject to the constraint that revenues must cover costs. Elegant and important insights ensued. The most important was that regulation was inevitably a struggle to achieve second-best outcomes. (Ramsey pricing was a splendid example.)

Reality proved harsh to regulatory theory. The firm's costs are by no means known to the regulator. At best, the regulator may know how much is currently spent to provide services, but hardly what costs would be if the firm vigorously pursued efficiency. Even if the current cost curve were known to the regulator, technologies change so swiftly that today's costs are a very poor indicator of tomorrow's, and those are the costs that will determine the firm's future decisions.

With the burgeoning attention to information considerations and game theory in economics, the regulator's problem of eliciting host information about cost has received considerable attention. In most cases, however, it has been in context that are both static and stylized; such analyses rarely capture many of the essential elements of real world regulatory issues.

This volume represents a fresh approach. It reflects Glenn Blackmon's twin strengths, a keen analytic mind and important experience in the regulatory arena. Within each chapter we see evidence of the time he has spent both in seminar rooms and hearing rooms. The product is an elegant blend of theory and practice.

Blackmon embraces the widely-held view that we must put more incentives into our regulatory system if managers of industries with declining average costs, such as utilities and cable systems, are to manage effectively on behalf of the public. However, he also recognizes the basic challenge that any incentive-oriented system must face: as regulated rates become more closely aligned with a firm's expenses, the incentive for the firm to reduce those expenses becomes weaker. He lays bare the essential tension between efficient production and efficient pricing.

This volume explores how regulators can deal with that tension, showing where and how regulators can break the links between a firm's expenditures and its revenues, thereby creating strong pressures for efficient production. Blackmon assesses a range of incentive regulation proposals, including some from the academic literature and some that have been implemented in the field.

Blackmon's central message is that regulation inevitably affects the incentives of the regulated firm. Regulators should understand that their function is to regulate incentives, as much as it is to regulate prices. The challenge of regulation thus becomes to provide adequate revenues, maintain strong incentives for cost control, and avoid sacrificing efficiency in pricing. Those who must struggle with these three competing considerations — be they regulators or scholars, consumer activists or producers — will be more than adequately rewarded by reading this volume. They will find an incisive formulation of the fundamental problems any system of price regulation must confront, complemented by sound thinking on the virtues and liabilities of alternative regulatory approaches.

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ACKNOWLEDGEMENTS

This book got its start as my doctoral thesis in public policy at the John F. Kennedy School of Government at Harvard University, or as they say in the academic literature, Blackmon (1991b). My thesis advisor, Richard Zeckhauser has, from the first time I walked into his office to talk about regulation, never expressed any doubt about my ability to think about hard problems and come up with solutions. His confidence in me as a student, scholar, and co-author inspired and motivated me. I also owe much to the other two members of my thesis committee, Tom Schelling and Glenn Loury, who served as role models for me long before they agreed to examine my thesis. To an extent they cannot realize, their presence on my committee was a powerful deterrent to sloppy logic and easy answers.

Harold Pollack upheld the fine tradition in our office of doing most of the hard work on his office-mate's analysis. I also appreciate those who read chapter drafts, listened to my ideas, and talked about the issues in this book: Chuck Adams, Steve Aos, Len Barson, Jack Donahue, Bruce Folsom, Darryll Hendricks, Bill Hogan, Martín Holtmann, Steve Johnson, Mark Johnston, Steve McLellan, Ted Parson, Jay Patel, Liz Thomas, Bethany Weidner, Luis Vazquez, John Vickers, and Ingo Vogelsang.

Susan Kavanaugh encouraged me to pursue this work, participated in thousands of discussions of incentives, allowed our lives to be disrupted while I worked on this project, and did more than her share of the work of the family. However, she did not tirelessly and cheerfully type countless drafts of this book.

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