Economics: Regulation and Trade

Natural Monopolies: occur when economy of scale is present and when a single firm can produce all the output at lowest per unit cost.

Economic Regulation: Government regulation on natural monopolies such as electric, telephone, cable companies. Monopolist maximizes profits at the production level where marginal revenue equals to marginal cost, however highest social benefit can be achieved at a production level where marginal social cost is equal to marginal social benefit.

In other words government regulation forces to increase monopolist and reduces the price levels.

Cost-of-service regulation: This is production level at the marginal cost or average total cost of monopolist. Regulators set the price to marginal social cost to increase the production and avoid dead-weight losses.
If the marginal cost is less than average total cost then monopolist face losses and demand subsidy to continue the operations, hence average cost pricing often used.

Another regulation is **rate-of-return** regulation where regulators set the price so that natural monopolies receive competitive rate of returns can be achieved.

Social regulation: is set to improve quality where buyers and sellers have different levels of information. Regulating authorities like SEC, FDA, and FAA regulate the industries where consumers otherwise wont have information transparency.

Increased regulations may negatively impact industries and all those costs eventually passed on to the consumers. Compliance expenses may be higher for smaller firms than larger ones and may negatively impact the competitive markets.
Other end safer products and cleaner environment, safer work environments are benefits of the social regulations.

Firms subject to regulations may attempt to avoid regulation or minimize costs associated with by various measures. One of them is ***Creative response*** where firms conform to letter but not intent. A firm may considers applications from all qualified job seekers but may choose certain applicants.

Feedback effect is creative response to regulation; high mileage for fuel regulation force automobiles more fuel efficient in return consumers drive more miles for the same amount of price spent on fuel.

Capture Hypothesis: Regardless how regulatory agency is established it is run by industry experts influenced "captured" by the industry. **Share-the-gain-and-pain** theory is regulators strive to satisfy legislators, consumers and industry, eventually pass the regulatory costs to customers.

Global Trade

The law of comparative advantage: Trading partners can be better off if they specialize in producing goods with lowest opportunity cost and trade for goods with high opportunity cost. Trade partners gain when exporting goods with low opportunity cost and import goods where they have high opportunity cost.

Tariffs: taxes imposed on imported goods. When global prices are cheaper than domestic goods then foreign producers have comparative advantage. Domestic producers may not compete with foreign producers. Government can impose tax (tariff) equal to price of domestic producers and collect the tariff from foreign producers.

With trade restrictions, supply curve in the supply-demand shifted upwards to meet new price and supply will be reduced to the higher price causes dead weight loss.

QUOTA: Similar to tariffs, importers are given license to import specific amount of goods. Supply is constrained to amount permitted under the license. Lower supply causes price increases, help domestic producers at the expense of domestic consumers.

Voluntary Export Restraints: voluntary imposition by foreign countries, how much goods can be exported under license.

Trade restrictions: Through free trade all countries obtain social benefits. Primary purpose of tariff is to collect revenue for governments and domestic producers influence government to impose tariffs to protect from foreign competition. In developing countries tariffs are another stream of revenue for governments.

Some arguments made to support trade restrictions:

- Infant industries need protection until they are ready to grow and compete.
- Foreign producers sell for less than production cost. (Anti dumping)
- National defense

Some arguments get little support among economists:

- **Trade barriers protect jobs**: Tariff on steel imports may help steel industry workers but workers at auto industry loose jobs and consumers pay extra price when buying cars.
- **Trade restrictions create jobs**: In short run may be, in long run opposite will happen. Trade partners loose purchasing power that is needed to buy from domestic exports. Higher domestic prices take away aggregate demand and reduced sales for domestic producers, and jobs created under imports are eliminated.
- **Trade with lower wage nations**: Higher wage not necessarily higher labor costs, productivity improvements through skills, invested capital; production methods reduce production costs even cheaper than lower wage countries. Rich nations have advantage of high tech goods versus lower wage nations have advantage over labor intensive industries.