

Comment on Simon Cowan: Price-cap regulation

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I find nothing to disagree with in Cowan's account of price-cap regulation, a measure perhaps both of the paper's brilliance and my own ignorance. Nonetheless, I would like to point out two questions that Cowan's analysis does not answer.

First, Cowan does not tell us *why* price-cap regulation suddenly became so popular. After all, the basic insights are old. Textbooks in microeconomics often analyze price ceilings in detail. We "always" knew that price ceilings reallocate a surplus from sellers to buyers, that deadweight losses shrink in the process, and that the incentive for cost reduction is improved as the price cap becomes tighter. Moreover, we understood a long time ago that monopoly distortions might be an acceptable price to pay for innovation and conversely, that the threat of a (tighter) future price cap depresses the investment incentives. Any student of economics has heard about the tension between short-run and long-run efficiency. Modern theories of incentives under asymmetric information allowed us to study all these well-known trade-offs coherently and in a more realistic setting. However, I doubt that this theoretical development played much of a role in promoting price caps in practice.

Given that we already understood the pros and cons of price caps, the surge in popularity must be due either to technological or political developments. Cowan himself hints at one potentially important technological development: As industries mature, new investments become less important, and hence the prospect of future price caps has a smaller cost in terms of lost investment. Might the decreasing role of new investment explain the change from rate-of-return regulation to price cap regulation?

Political developments that have facilitated price-cap regulation are also easily identifiable. Many of the regulated firms were previously publicly owned firms, and in several cases the price cap merely replaced an administratively set price. Possibly, regulators have also become more trustworthy over the last decades. Increased credibility

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could trigger regulatory change, because the main problem with the price cap, as Cowan notes, is the potential lack of credibility. If promises not to expropriate quasi-rents have indeed become more credible over time, it would be very interesting to know why.

My second concern is that it appears possible to do better than standard price-cap regulation. For example, the price cap could be adjusted each time marginal costs decrease, with adjustments being accompanied by a transfer from the regulator covering the firm's lost revenue. Why do we not see these more efficient schemes?

Positive theories of regulation need to explain both the sudden success of price-cap regulation and the failure to adopt seemingly superior schemes.