Microeconomics, Module 14, “Collusion, Cartels, and Regulation”

Required reading for seventh edition:

(The attached PDF file has better formatting.)

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{The Landsburg textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Read section 11.2 from pages 368 through 371; skip “tit-for-tat” on pages 371-372; and read “The Prisoner’s Dilemma and the Breakdown of Cartels” on pages 372-375.

Cartels, enforcement, and the prisoner’s dilemma were highly relevant to the insurance industry for most of the twentieth century; they are less relevant now, but the economic theory is still important. Insurance rating bureaus, which were common in the property-casualty industry for much of the twentieth century, are cartels, though they have many social benefits as well. It is hard to monitor insurers’ activities, since prices depend on the characteristics of the applicant. No two applicants receive the same life insurance rate or the same auto insurance rate, so it is hard to know if one member of a cartel is under-pricing (cheating). This is the prisoner’s dilemma that the text refers to. The homework assignment asks about the cheating problems in an insurance cartel.

Read carefully the “Government as Enforcer” on the top of page 375; almost all criticism of insurance industry rating bureaus has the government as enforcer of industry rates. Fifty years ago, state regulators and rating bureaus prevented insurers from reducing rates below the approved amount; now insurers can reduce rates freely in most states. The homework assignment asks about possible government action as enforcer of a cartel vs defender of low rates for consumers.

Skip most of section 11.3 except for regulating prices on page 379. The states regulate insurance rates, though the rationale for regulation is disputed. Rate of return regulation is common, though this type of regulation is often ineffective and counter-productive. Actuaries disagree whether rate of return regulator in the insurance industry is useful.

Two of the examples in this section are fascinating: “The Economics of Polygamy” on pages 380-381 and “Affirmative Action Laws” on pages 382-383. They are not tested on the final exam, but you will enjoy reading them.