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

Micro module 14: Readings for ninth edition

(The attached PDF file has better formatting.)

{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 skipped sections are fascinating but are not tested.}

Read section 11.2, "Collusion and the Prisoner's Dilemma: An Introduction to Game Theory," on pages 366-369. Skip “tit-for-tat” on page 369, but continue with “The Prisoner’s Dilemma and the Breakdown of Cartels” on pages 369-373. Landsburg illustrates with well-known cartels, such as college athletics.

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 or 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 cheating problems in an insurance cartel.

Read carefully the “Government as Enforcer” on page 372; 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 government action as enforcer of cartels vs defender of low rates for consumers.

From section 11.3, read "regulating prices" on page 379 and "regulating business practices" on pages 379-80. 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 regulation in the insurance industry is useful.

The sub-section “The Economics of Polygamy” on pages 377-378 is fascinating. It is not tested on the final exam, but you will enjoy reading it.

Read "What can regulators regulate" on page 378. Stigler founded the modern economic theory of regulation.

The sub-section "Affirmative action laws" on page 379 is an excellent example of Landsburg as the political economist. The final exam does not test affirmative action, but you will enjoy this section of the text.

Review questions R6 and R7 on page 389. Many large insurers want strong solvency regulation and rate regulation. They want to avoid underwriting cycles and other systematic fluctuations in profitability. If the states require steady rates and high capital requirements, they expect even profits for long periods.

Review problem 7 on page 392. The problem sounds silly to young actuarial candidates, who may not realize that it reflects the airline industry before price deregulation.

Read problem 12 on page 393. This is not tested on the final exam, but is shows how cartel pricing and collusion exists not just in business but also in unions. This is the political economist speaking; most economists agree with Landsburg's views.