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

Micro module 14: Readings for tenth 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." Final exam problems give you the payoffs from various cells of a two-person game and ask you to identify certain game theory attributes. Landsburg illustrates the theory 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, were cartels, though they have since discarded their cartel-like attributes and 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”; 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.

Section 11.3 is especially relevant for actuaries. 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. “The Economics of Polygamy” is fascinating, though it is not tested in this course. Read "What can regulators regulate"; Stigler founded the modern economic theory of regulation. The sub-section "Affirmative action laws" 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 question R7. 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 end of chapter problems 11, 12, 13. Competitive firms of similar size often charge the same price, and a more efficient firm may choose to charge the market price to avoid price wars in the industry. Cartels are risky; few industries in the United States form cartels because the criminal fines are so high. Whether unions help or hurt workers is debated. These questions have no simple answers.

Read problem 12. This is not tested on the final exam, but is shows how cartel pricing and collusion exist not just in business but also in unions.