23. Licit and Illicit Responses to Regulation

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1. Introduction

New regulation can elicit a great variety of responses from individuals, firms, interest groups, and bureaucracies. This chapter examines a range of common legal and illegal behaviors that arise as responses to new regulations. It also compares the approaches that new institutional economics and neoclassical economics use to study these responses. The motivation for introducing new regulation is generally to influence behavior: to promote or restrict competition, to redistribute income, to increase or reduce barriers to entry, to increase or reduce spillovers, and so on. However, regulation often influences behavior in ways that differ from the initially stated rationale. This chapter focuses on the consequences of regulation, on this wide range of responses, rather than on the rationale offered for introducing the regulation.

In economics, the standard literature on regulation emphasizes two dimensions of response—money price and quantity—and neglects other dimensions. This limited focus reflects the small number of variables emphasized in the standard theory, a desire for parsimony, and limited data. However, responses across many dimensions are possible. There is no *a priori* ground for believing that the standard price-and-quantity responses or the income effects are always the most significant ones. We need to discover which consequences are big and which are small, to learn how various effects play out over time, and to understand the conditions under which a particular type of response is likely to occur. On occasion, a single small regulation may cascade into a large regulatory system. At other times, an apparently Draconian regulation may be greatly weakened in its effects by inventive adaptations along various margins.

The range of possible licit and illicit responses to regulation shown in Table 1 illustrates some of the approaches taken by new institutional economics to the study of regulation. Although far from exhaustive, this set is much greater than the set usually examined in the standard literature on regulation.

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 591–608.

Table 1. Categories of responses to regulation

Licit responses	
Substitute	*for*
Other goods	Regulated good
Other attributes of good	Regulated attributes
Amenities	Profits in excess of regulated maximum
Barter and other arrangements	Money
Vertical integration	Market exchange
Household production	Market production
Personalized exchange	Impersonal exchange
Alter	
Governance and contractual relationships	
Organization of the market	
Interest groups and their goals	
Other formal regulations	
Informal norms	
Illicit Responses	
Vary the extent of	
Underground economy	
Private coercion and extralegal organizations	
Discrimination	
Corruption	

2. Licit Responses to Regulation

Substitution of Other Goods

If a regulation raises the price of a given good, consumers will tend to consume less of that good and to substitute other goods. The standard neoclassical model focuses principally on this effect.

At a given time and place, the set of goods available in the marketplace is merely a subset of all goods that are potentially available. The set existing in the marketplace is established as the outcome of an equilibrium process that depends on competition, production possibilities, income, and the formal and informal rules of the game. Changes in regulation can affect these factors and hence change the available set of goods. This can alter the range of substitutes available to consumers.

Substitution of Attributes of Goods

Regulation also affects the equilibrium attributes of goods. Even "simple" goods have many attributes beyond their money price, such as size, color, quality, reliability, warranty, availability of credit, associated service, location, and waiting