

THE REGULATION PROBLEM

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THE PROBLEM

Regulation (in theory) increases public welfare by encouraging beneficial behavior and discouraging detrimental behavior using laws, rules, requirements and procedures. Since regulations create overnight winners and losers, interest groups lobby for regulations that benefit them but may not benefit the public.

Unfortunately, interest groups are not the only barrier to “optimal” regulation. Regulators can act as an interest group—writing or implementing regulations that serve their financial or ideological interests. Because regulators have monopoly power, their self-serving actions may be more damaging than those of interest groups.

So regulation will not maximize public welfare if interest groups or regulators are able to change regulations to serve their own interests at the expense of everyone else. This conclusion seems pretty straightforward, but can we use it to improve the quality of regulation and public welfare? No, not until we consider the problem of asymmetric information.

Although interest groups and selfish regulators may want to affect regulation, they can only succeed because it is hard for outsiders to understand the quality of the regulators and/or the impact of regulations. Put differently, incompetent or corrupt regulators and/or sub-optimal regulation are more likely when outsiders do not know what’s going on.

For the remainder of this piece, I will discuss this “regulatory problem,” i.e., how regulatory self-interest combines with asymmetric information to produce sub-optimal regulation, how to solve that problem, and how to implement these solutions.

UNDERSTANDING REGULATORS

Regulators make, interpret and enforce rules. Although “good” regulators may use their power and discretion with restraint and wisdom, it is easy for regulators to abuse their power.¹ Although it seems like “watching the watchers” can alleviate abuse, this “solution” will not work when regulators know more about themselves and/or their actions, i.e., if they have an asymmetric information advantage. It is this environment of asymmetric information that underpins regulatory failure.²

Put another way, it is easy to see that a car thief is taking your car, but it is hard to know if one’s regulatory burden is the result of a decision that benefits society or a decision that benefits the regulator.

Although it is “efficient” to have a single regulator on a single issue—minimizing coordination problems, concentrating knowledge, clarifying authority, maximizing consistency, etc.—the lack of competition makes it difficult to judge the efficiency of an honest and earnest regulator, let alone an abusive one. Abuse of monopoly power can be curtailed by reputation (i.e., subjecting regulators to scrutiny at re-appointment or allowing periodic competition for the position), but this solution will not be effective when it is hard to even measure a regulatory outcome.

In the theory of public choice regulators care about themselves not the public.³ Note also it is easy to divide the public into passive “masses” and active “special interests”—each of which may claim to represent the interests of society. The masses benefit when the politicians and regulators do their jobs; special interests benefit when they do not serve the masses, and they are willing to bribe politicians/regulators to get such an outcome.

¹Abuse occurs through incompetence, megalomania or greed; see Shleifer (2005) for an excellent overview and Damania (2002); Jamison (2005) for, respectively, pessimistic and optimistic applied studies.

²For more on asymmetric information and the principal-agent problem, see Akerlof (1970); Spence (1973); Rothschild and Stiglitz (1976).

³Experiments have shown that regulators are just about as self-interested as “selfish” citizens, which makes it hard to believe that they will act for the benefit of the public if it means a foregone, selfish benefit.

it is not hard to extend regulatory self-interest to include a “captured” regulator, who works for the interest group he is supposed to regulate. Although overall wealth declines (harming the public), the regulator and his paymasters benefit from the bad regulation.⁴

Given the typical (and reasonable) assumption that regulators are self-interested, the problem of discovering if the regulator is qualified (type) and/or does the right thing (action) can only be solved by passive screening mechanisms (using tests of competence to filter types) or active monitoring (watching actions or measuring outcomes to affect behavior).

This task is complicated in government because the cost of screening and monitoring is borne by those who do not directly benefit from good regulation. In essence, the Public delegates these tasks to politicians, who are supposed to represent the public interest in ensuring that regulators are both competent and serving the public interest. The complicated interactions of regulators, special interests, politicians and citizens are difficult to describe, but it should not be hard to imagine scenarios where outcomes do not maximize public welfare.

IMPROVING REGULATION

So how can we solve the problems of monopoly, self-interest and capture when asymmetric information makes it difficult to know if regulators are qualified and/or act in the public interest? In this section, I discuss how values, competition or empowerment can improve regulation. In the following section, I consider ways to implement these ideas.

The easiest “solution” is to have regulators who give as much weight as possible to public welfare. The trouble with this notion is that its hard to discriminate between regulators who do care and those who *say* they care but do not. Although the balance between selfish and selfless can change if social groups and/or institutions admire and/or reward one ideal over another, we ignore this “be nice” solution.

⁴See Buchanan and Tullock (1962); Stigler (1971); Krueger (1974) on these concepts.

One institution that will push regulators to do their jobs is measuring outcomes against an objective performance rule. For example, a regulator charged with attaining an air quality of x particles of SO₂ per million could be left to his own devices but judged according to outcomes. Measurement of outcomes (test scores, life span, crash worthiness, sales volume, etc.) can alleviate almost all problems of asymmetric information on the input side. Of course, it is important that the targeted goal be worth measuring and that the measurement be accurate.⁵

Although measurement may be possible, it may not be possible to state an objective goal. One way to get around that problem is by comparing and rewarding regulators for their relative outcomes, i.e., yardstick competition.⁶

With even less information, it is possible to improve outcomes by inducing competition among regulators. Governments, like businesses, will only serve citizens or customers if competition or the threat of entry forces them to do so. Fortunately, competition does not require outside observation of what regulators say or do. Behavior give a summary indicator of regulatory effectiveness, e.g., corporations that establish their headquarters in Connecticut.

Even without knowing the exact nature (quality or quantity) of inputs or outputs, it is possible to increase regulatory quality through transparency and lowering the cost of monitoring, e.g., broadcasting and archiving regulatory hearings on the internet.

Regulatory effectiveness can also be increased by involving and empowering “stakeholders,” i.e., those who are interested in and affected by regulation. With regulatory negotiation, for example, all stakeholders can veto regulatory change. This time-consuming method of setting rules can breakdown if one party refuses to accept a rule, and the results may seem bizarre to outsiders, but it can work in areas where ex-ante uncertainty and/or incomplete contracts make it difficult to impose fixed rules.

⁵Wilson (1989) has a good discussion of how bureaucrats like to measure inputs (number of regulations) or outputs (number of fines) instead of an outcome that matters (net social benefits).

⁶See Shleifer (1985); Shimshack and Ward (2005) for a discussion.

IMPLEMENTING SOLUTIONS

Let us consider how to implement these methods—ordered from simplest & hardest to implement to complicated & easiest to implement. Simple means that the cost of implementation and results-interpretation is low. Implementation is hard when the regulator must act and easy if anyone can.

Measurement and Benchmarking. Assuming that *outputs* (e.g., rulings) or *outcomes* (e.g., changes in welfare) can be measured, it is easy to reward or punish regulators relative to a predefined goal.⁷ For example, the EPA gets a reward if it settles X regulatory disputes (output) or reduces pollution to Y percent (outcome) and is punished if it does not.

With benchmarking, regulators virtually compete against the same measuring stick of outputs or outcomes. Benchmarking is better than measurement when the future is uncertain or the goal is continuous progress, e.g., ranking regulators by the percentage of their regulations rejected by courts.

Competition. Regulatory competition can be induced by virtually dividing a regulator into competing teams. If, for example, the FDA had teams (A, B, C...), drug companies could submit applications to any or all teams, which would then compete to judge the claim. If incentives were adequate (a BIG if), the teams would work harder to approve/deny the application.⁸ Stakeholders, non-participating teams, companies, consumers, doctors, et al. could decide which team did the best job—or create a “virtual” winner that combined the best elements of various teams.

De facto and de jure competition already exist where states compete (e.g., corporate laws) or issues regulations that are binding on other states (e.g., marriage laws). Indirect competition (via, e.g., banking regulations, organic standards, drinking laws, air-quality

⁷The government of New Zealand has extensive experience with measurement. Political leaders who pledge to reach outcomes make contracts with bureaucrats who promise to produce outputs in exchange for funding. The entire process takes place in public, and achievements are compared to promises.

⁸Although the race to approve/deny might result in poor or biased decisions (a problem that may already exist), competition would at least allow for outside review and comparison to other team efforts.

laws) is unpopular with those who want predictability but popular with advocates of states' rights and those who worry that corporations use federal law to pre-empt and quash troublesome state laws.

Transparency. Regulation will indirectly improve if it is easier to monitor regulatory activity (what, how, where, when). This transparency can be volunteered from the inside or forced from the outside; outside transparency is easier to implement but suffers from illegitimacy (interest group bias, unofficial data, etc.).⁹

Transparency (e.g., posting information in a public space) can be augmented by feedback (e.g., public comments) and interaction (e.g., public revision of regulations). For example, regulators can post approved and proposed regulations on a wiki to allow anyone to comment on wording, clauses, and mechanisms.¹⁰

Although more input worries regulators who want control over process and information, it is likely to improve the quality of regulation. Technology offers several solutions—from focusing and reconciling comments (e.g., digg.com), to mashing up voting and campaign contribution databases (e.g., MAPlight), to cross-linking to related material (biographies, laws, bills, regulation, history, etc.)

Even so, it is not clear how to “crowdsource” contentious, hypothetical compositions like regulations.

SUMMARY

Regulations are supposed to improve outcomes at a reasonable cost. Since regulations are often vague and incomplete (intentionally or not) and outcomes are hard to measure, regulations can be interpreted and manipulated in ways that worsen outcomes and/or increase

⁹See Noveck (2004); Brito (2007); Noveck (2008) for more

¹⁰This wiki approach is now in use at http://webstandards.govt.nz/index.php/Home_page—a working project of the NZ government. <http://www.washingtonwatch.com/> allows the public to comment on bills and reconcile their comments into pro and con positions using a wiki. The wiki is not very popular—perhaps because one must reconcile one's thinking with others.

costs. I describe how explicit and/or implicit information (i.e., measurement, benchmarking, competition and transparency) can be used to reduce such negative outcomes.

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