

Regulation and Economics

EDITED BY
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AND
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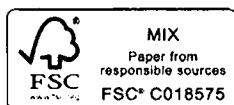
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An introduction to the law and economics of regulation

Alessio M. Paccas and Roger J. Van den Bergh

1. ECONOMICS OF REGULATION AND THE PURPOSE OF THIS BOOK

The goal of this book is to offer the reader a non-technical, but scientifically rigorous, overview of the major themes in the economics of regulation. This is a very ambitious goal for at least two reasons. First, regulation is ubiquitous. It is virtually impossible not to be confronted with regulation in a typical day of our life. Second, regulation of different activities raises different issues. Although the economic explanations and rationales for regulation can be conceptualized in certain categories, they interact quite differently depending on the specific activity in which individuals and firms engage. A few examples may help clarify both points.

We all use electricity, gas and water on a daily basis; most of us use transportation and telecommunication services with the same frequency. The provision of these services is extensively regulated, and the fundamental reason is that parts of the supply chain of these services present natural monopoly features. Natural monopoly implies that supply of a certain service or part thereof is economically viable only in the presence of a monopolist, which raises a number of problems. The most obvious difficulty for consumers is high prices and limited supply, both of which are countered by regulation. However, other problems may just be subtler. They tend to be industry-specific. Water, for instance, presents important safety issues. For electricity, there are problems of efficient generation and environmental impact. These and similar problems suggest that keeping prices low in industries that cannot be entirely exposed to competition may not be the only goal of regulation.

Equally important is the fact that regulation does not only operate in the presence or in the proximity of a natural monopoly. Going back to the examples from our daily life, we all drive cars that are safer than 20 years ago. This is largely due to safety regulation. Cars also pollute less, which depends on environmental regulation. Cars have become more expensive for these reasons. This raises two additional questions. First, one may wonder whether it is economically efficient for individuals to pay for safety and environmental-friendliness if

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they do not value these features sufficiently. Second, one may suspect that behind increasingly sophisticated regulatory standards lies the automobile industry's interest in stimulating demand for new cars. Car manufacturers in a particular EU country may also favour harmonization of safety standards if it provides them with a competitive advantage over their foreign rivals. As it turns out, the compulsory character of regulation and regulators' dependence on the industry for information make both questions essential for regulatory analysis.¹

Finally, regulation is often contested. It is not uncommon for public opinion to blame regulation for anything that goes wrong. Curiously, the blame can go in opposite directions depending on whether, at a certain point in time, the market economy is overall delivering gains or imposing losses on society. In the first situation, regulation is often perceived as an obstacle to capturing opportunities for profit, growth, and well-being; thus, markets should be 'liberalized' or 'deregulated'. In the second situation, it is often said that regulation has failed to stop market forces from undermining social welfare; therefore regulation should be 'strengthened'. Examples of these swings between pro-regulatory and anti-regulatory sentiment are abundant these days. One instance is the different attitude towards financial regulation before and after the global financial crisis. Another topical example is the changing attitude towards risks and safety regulation after the disaster of Fukushima. In both cases, one observes a shift from a critical to a more positive attitude towards regulatory intervention. These swings explain many of the political determinants of regulatory reform, thereby affecting the ability of regulation and deregulation to actually enhance social welfare.

In this book we try to address systematically the above set of questions and others that are more specific to the regulation of certain activities or industries. The research question throughout the book is the economic logic underlying regulations. This implies two kinds of exercise. On the one hand, the economic justifications for regulation, namely the reasons why society *should* be better off with regulation, need to be analyzed. This is known as the *normative* approach to regulation. On the other hand, the interests and the forces that shape regulation, making it look the way it *is* regardless of how it should be, must be discussed. This approach is known as the *positive* theory of regula-

¹ The answers – for those not familiar with the law and economics approach – lie in the public and the private interest theories of regulation. The public interest rationale for safety and environmental regulations that make products more expensive is the efficient control of externalities, which should improve social welfare. However, the actual development of safety and environmental standards is influenced by the industry's lobbies, which pursue private interests that do not necessarily enhance the welfare of society. See *infra*, Chapter 1 by Den Hertog.

tion. We have asked prominent experts in specific regulatory fields to perform these exercises, sticking to a comparative law and economics methodology (see De Geest and Van den Bergh, 2004). This implies, most importantly, that the economic analysis of regulation in each chapter of this book is not confined to a specific institutional setting. Although some chapters, for instance Chapter 3 by Rubin and Chapter 4 by Cseres, focus on one jurisdiction or group thereof, this book always takes a functional approach to regulation. This implies that the economic analysis of regulation, both positive and normative, holds regardless of the specific legal environment in which it is applied. This approach to the economic analysis of law naturally enables the comparison of different forms of regulation, which is effectively performed in the vast majority of the chapters of this book. In addition, because this approach is applied to real-world instances of regulation, it is more concrete than the formal analyses prevailing in the theoretical, economic literature.

This volume belongs to the second edition of the *Encyclopedia of Law and Economics*. In contrast to the first edition, each volume is now more self-contained and so are the individual chapters. In addition, the emphasis is on scientific discussion of the state of the art on certain law and economics subjects rather than on the inclusiveness of the bibliography. However, the major difference from the first edition is the significant update of the academic and policy debate on single regulatory items. Whenever possible, we have asked the contributors to the previous edition to write a chapter for this book. This has not always been possible particularly because we have taken the opportunity to expand the coverage of topics in regulation, on which there was no separate volume in the first edition of the *Encyclopedia*. As a result, many of the chapters of this book are entirely new. Still, this book only covers some of the most important subjects in regulation. It is simply impossible to cover them all, and we had to use considerable discretion in selecting the topics. However, we have tried to illustrate all the major areas in which regulation takes place by presenting them in a consistent structure. Before explaining this structure, we need to be more precise about what we mean by regulation and the economic problems underlying it.

2. WHAT IS REGULATION AND WHY SHOULD IT MAKE ECONOMIC SENSE?

Definitions and understanding of regulation vary considerably (see Baldwin and Cave, 1999). For economists, regulation is often a synonym for government intervention in markets. In particular, a distinction is made between contracts and regulation, the former being the private discipline of transactions enforced by courts and the latter being the public discipline of transactions

enforced by governments (Shleifer, 2011). While interesting, this understanding of regulation tends to be over-inclusive and may lead to confusion, for instance with regard to mandatory rules in contract law and tort law. Although these rules undoubtedly constitute forms of government intervention in markets, they do not qualify as regulation *stricto sensu*. In defining the boundaries of regulation, also with the purpose to avoid overlaps with the other volumes of the Encyclopedia of Law and Economics, we rather take stock of the distinction between private and public law in the Civil Law tradition. Both bodies of law include legal rules affecting the functioning of markets. However, private law focuses on the individual rather than on the collective dimension. For this reason, the vast majority of private law rules can be opted out of by mutual consent, are backed by private sanctions, and are enforced individually in courts. In contrast, public law is mainly compulsory, backed by criminal or administrative sanctions, and it is enforced by the government or its agencies. For the purposes of this volume, by regulation we mean the discipline of individuals' and firms' behaviour through *legal rules* which are defined by the following three attributes: *compulsory*, backed by *criminal/administrative sanctions*, and *publicly enforced*.²

It is well understood that regulation, especially in its more interventionist definition sketched out above, should be justified. Governments may pursue different goals through regulation, but in one way or another they need to take economic efficiency into account. Even when economic efficiency is not a goal in itself, economic analysis sheds light on the costs of certain policies in terms of efficient use of resources (Viscusi et al., 2005). In this book, as in the rest of the Encyclopedia of Law and Economics, economic efficiency is assumed to be the normative criterion for legal analysis. As a result, regulation is economically justified when it is efficiency-enhancing. Because – since Adam Smith's (1776) celebration of the 'invisible hand' – free market exchange is deemed to lead to the efficient allocation of resources, regulation can only improve on market outcomes when markets malfunction. Thus, at least from a normative perspective, regulation is justified in the presence of one or more market failures.

Market failure is a notion of neoclassical economics, meaning departure from one of the conditions of general economic equilibrium in the allocation

² See e.g. Ogus (1994). It may be objected that the distinction between private and public law is becoming blurred. For instance, private enforcement is increasingly relying on collective action tools, particularly in the area of consumer protection. On the other hand, public law is gradually moving from command-and-control forms of regulation to more market-based instruments, e.g. the trading of emission permits. This volume discusses these grey areas as well. See, for instance, Chapter 4 by Cséres and Chapter 5 by Faure.