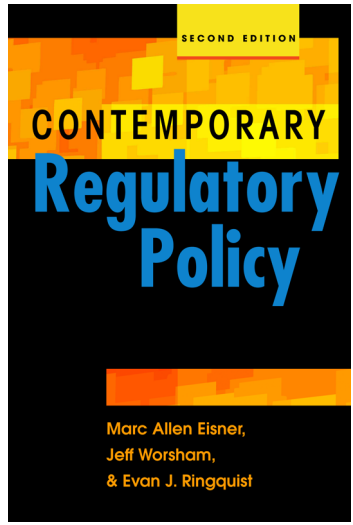
EXCERPTED FROM

Contemporary Regulatory Policy

SECOND EDITION

Marc Allen Eisner,
Jeff Worsham, and
Evan J. Ringquist



ISBNs: 1-58826-411-4 pb

LYNNE RIENNER PUBLISHERS
1800 30th Street, Ste. 314
Boulder, CO 80301
USA
telephone 303.444.6684
fax 303.444.0824

Contents

1

A Primer on Regulation

GOVERNMENT REGULATION of business has been contested ground in the political contests and rhetorical wars of the past several decades. To critics on the right, regulation describes governmental forays into social engineering designed to undermine markets and encumber corporations with any number of politically defined duties and compliance costs (the so-called regulatory burden). To advocates on the left, regulation describes the positive use of public authority to hold corporate America accountable, a goal that is deemed worthy given the immense power exercised by the modern corporation and the lack of any other direct means of forcing businesses to accept responsibility for workplace injuries, environmental degradation, and potentially hazardous consumer products. The term regulation has become something of a code word for government intervention. Unfortunately, the regulatory debates have often brought more heat than light; there is scant evidence that there has been much of a connection between one's willingness to enter the debates and one's knowledge of regulatory policy. This volume is designed, in large part, to provide a relatively detailed overview of regulatory policy and administration in several issue areas. Readers of this volume should have a clear understanding of the key policies and agencies in a variety of these areas, as well as an appreciation for how (and why) patterns of regulation have changed over the course of the past several decades. We need to preface our discussion with some important preliminary material. Specifically, in this chapter, we develop a definition of regulation, survey the justifications and explanations offered for regulation, examine a host of regulatory tools, and introduce competing explanations typically offered for regulatory policy change.

What Is Regulation?

Regulatory policies are a subset of public policies more generally, so it is useful to begin with a somewhat broader question: What is public policy? James Anderson defines policy as "a purposive course of action followed by an actor or set of actors in dealing with a problem or matter of concern" (1984: 3). Similarly, Clarke Cochran and colleagues define public policy as "an intentional course of action followed by a government institution or official for resolving an issue of public concern" (1990: 2). At first glance, this has much to commend it. The focus turns to patterns of action, as opposed to mere rhetoric or symbolic statements of intent. More important, policy is concerned with goal-oriented behavior rather than random acts. Yet there is a problem, as Thomas Dye reminds us that "we can never be sure whether or not a particular action has a goal, or if it does, what that goal is. . . . All we can really observe is what governments choose to do or not to do" (1992: 3). In the end, Dye's definition is quite minimalist: "public policy is whatever governments choose to do or not to do" (1992: 4). The movement away from intentions is useful. They cannot be observed, and it is difficult to make a connection between statements of intent and patterns of action, given that the former may provide an ex post facto justification of the latter. We depart from Dye, however, on the issue of choice. The patterns of public action that constitute policy are the products of a complex interorganizational system and bureaucratic routines (see Chapter 2). While there are choices, they are often distorted by organizational routines that constrain the opportunity set available to decisionmakers. As a result, it makes sense to adopt an even more minimalist definition of policy as patterns of governmental action and inaction.

This does not mean that we are unconcerned with issues of intentionality and choice. Yet human agency must be understood as being constrained by structure. Decisionmakers operate within a dense organizational context in which a given set of values, methodologies, bodies of expertise, and policy tools are favored over others. When making policy, decisionmakers situate current policies in relation to past initiatives, often seeking to reconcile new initiatives with existing organizational capacities. Nor does this minimalist definition mean that we are unconcerned with policy impacts. We must focus attention not only on what the government does (the patterns of action), but also on whether such actions actually reduce problems, on whether they do so in ways that are cost-effective, and on whether this is accomplished without giving rise to a host of unintended consequences that impose costs that exceed the benefits of government intervention.

What of regulation? One may follow Kenneth Meier, who notes that "regulation is any attempt by the government to control the behavior of citizens, corporations, or subgovernments" (1985: 1). Such a definition may

appear too broad at first. All public policy is designed to coerce certain patterns of behavior. If control were unnecessary, the desired results would be forthcoming without governmental coercion. A narrower definition would seem appropriate. In this volume, the term *regulation* will be used to describe an array of public policies explicitly designed to govern economic activity and its consequences at the level of the industry, firm, or individual unit of activity. As this definition suggests, we are not concerned with policies affecting economic activity at the macroeconomic level, but with policies that function directly at a microeconomic level. A useful distinction that we retain is made between traditional economic regulation and the new social regulation. *Economic regulations* govern conditions under which firms may enter and exit the market, competitive practices, the size of economic units, or the prices firms can charge. Economic regulations commonly target a single sector of the economy, and the jurisdiction of the agencies that administer these regulations is generally limited to a single economic sector as well. Most of the regulatory initiatives introduced during the Progressive Era and the New Deal were economic regulatory in nature. The *new social regulations,* in contrast, are designed to force corporations to accept greater responsibility for the safety and health of workers and consumers, as well as for the negative by-products of the production process. They also address various social issues that are not directly economic (e.g., equal opportunity in employment). In clear contrast with economic regulations, social regulations apply across sectors; the associated agencies must regulate on an economy-wide basis. Because they impose large costs on firms, they are bitterly opposed by the regulated parties. Although social regulations have been introduced throughout the history of regulation, they became dominant after the late 1960s, as quality-of-life issues became more salient.

Why Regulate?

Given the diversity of regulatory policies, there is no single explanation of why governments regulate. One can identify several rationales for regulation, each of which is premised on a particular vision of governmental authority and expectations concerning how this authority will be exercised. Each provides some important insights. We restrict our attention to five explanations:

1. Regulations are public policies designed to further the "public interest."
2. Regulations constitute efforts to prevent or compensate for market failure.

3 Regulations are the product of industry demands for wealth transfers.
4. Regulations are the product of agencies captured by regulated industries.
5. Regulations are the product of the competition among regional political economies.

These explanations of why governments regulate are not mutually exclusive. Indeed, several may be simultaneously correct.

Regulation and the Public Interest

The first portrayal of regulation reflects the normative assumption that regulation is the application of public authority to further the "public interest." An early use of this rather amorphous concept in regulation was the Supreme Court decision in *Munn v. Illinois* (1877). In this dispute, state regulators had required that owners of grain elevators be licensed and observe legislatively determined maximum rates. When the regulation was challenged, the Court sided with the state, arguing that the extension of regulatory authority was acceptable given that it was a business "affected with the public interest." The Court continued, arguing that this "affectation could logically be extended to transportation, water supply, telephone, electric and gas manufacturing and transporting companies," opening the door to increased government activity (Sanders 1981: 19). In fact, many of the regulatory agencies created at the national level in the next several decades were directed by statute to regulate in the public interest.

What precisely is the public interest? Presumably, the consuming public has an interest in fair prices, honest dealings, and safety that could be secured effectively through regulation. The problem is, the public interest is often used to legitimize self-interested claims. As Deborah Stone notes: "there is virtually never full agreement on the public interest . . . so much of politics is people fighting over what the public interest is and trying to realize their own definitions of it. Let it be an empty box, no matter" (1988: 15). Be this the case, it is difficult to determine what is gained by adopting a public interest explanation of regulation.

Regulation and Market Failure

Competitive markets allow for a relatively cost-free exchange of property and facilitate an efficient allocation of goods via the price mechanism. Prices signal consumers to make substitutions in their consumption decisions; they signal producers to alter their production levels. Prices also signal producers to adjust the mix of inputs they use, leading them to place a greater emphasis on resources with lower prices. When prices exceed mar-

ginal costs, thereby resulting in abnormally high profits, firms are induced to enter the market, expanding supply and eroding monopoly profits. Given the importance of these functions to society, one should not be surprised that market maintenance is an often-cited justification for regulation. There are several conditions deemed essential for perfect markets: (1) there must be a sufficient diffusion of economic power such that all actors are price takers; (2) there must be no public goods; (3) there can be no externalities—that is, all costs must be borne by the parties to an economic transaction; (4) buyers and sellers must have complete information; and (5) there can be no transaction costs (see Stokey and Zeckhauser 1978: 297–317). Of course, this is an idealized state of affairs. If any of these conditions are not met, this ideal is compromised (i.e., market failure occurs). Markets are relatively robust, however, and can continue to function even when some of these conditions are violated. Nevertheless, many argue that regulatory policy is necessary as a means of preventing or compensating for market failure. Let us briefly note how regulatory policies may help address some of the key sources of market failure.

Firms as price takers. A first and most important condition for competitive markets is a decentralization of economic power such that each actor is a price taker (i.e., no buyer or seller should be able to influence the price of a good through independent action). When firms exercise such market power, markets fail. One regulatory response has been antitrust (see Chapter 4), which controls mergers and the use of various nonmarket restraints, such as cartels and price-fixing. There are instances, however, in which promoting competition would impose large costs on society. In certain industries, very large economies of scale may create a situation of *natural monopoly.* A natural monopoly exists when the average cost of producing a good declines over the relevant range of demand for that good. Under these circumstances, a single large producer will be able to manufacture the good at a cost no competitor can match. Monopolies tend to be allocatively inefficient. To maximize profit, they restrict production below the level that would be socially optimal and charge higher prices than those obtainable in a competitive market (i.e., they extract monopoly rents). Promoting competition will not help. A more decentralized economic structure might provide the same level of output, but it would do so at a higher price. Regulators may, as a result, opt for a regulated monopoly and guarantee a certain rate of return in hope of creating incentives to produce at a level that would meet demand (see Averch 1990: 34).

Public goods. All public goods share two characteristics: nonexcludability and nonrivalry. *Nonexcludability* occurs when it is impossible or prohibitively expensive to prevent those who do not purchase the good from con-

suming it. *Nonrivalry* means that one actor's enjoyment of the good does not reduce or prohibit the enjoyment provided to others. By their very nature, public goods are impossible to provide through the market. No entrepreneur will produce a good for which they can neither restrict access nor charge a price. Take the example of clean air, a classic public good. Because of nonrivalry and nonexcludability, it would be irrational for individuals to voluntarily devote resources to the attainment of clean air by paying to reduce air pollution. The rational individual would free-ride (see Olson 1965). Clean air would thus be characterized by nonprovision or gross underprovision. Environmental Protection Agency (EPA) regulations have dealt with this situation by forcing polluters to employ control technologies. The costs are borne by the firms, but also by consumers via prices and by the population as a whole via taxation.

Externalities. An externality is best understood as the difference between the private costs and benefits of a given product and the costs and benefits absorbed by society. For the price mechanism to function effectively, all costs must be reflected in prices. There are legitimate reasons for wanting prices to internalize all costs of production. Without internalizing the costs, society is essentially subsidizing production, and, as a result, the industry is overproducing. EPA regulations are excellent examples of policies designed to force this internalization of costs by requiring firms to control their release of pollutants (see Chapter 7). Occupational Safety and Health Administration (OSHA) regulations are examples of policies that force corporations to internalize the costs of injury or disease associated with the production process (see Chapter 8). Many critics of social regulation complain that regulations have increased costs and limited production and reinvestment in certain industries. What these critics fail to realize is that this is precisely the point.

Complete information. Although market actors are assumed to rationally pursue their self-interest, it is difficult to make rational decisions concerning whether one will benefit from the purchase of a given product or service at the market price under conditions of *information scarcity* or *information asymmetry.* Producers have more information regarding the cost and quality of a good than do consumers. This is especially true for *experience goods* (i.e., goods for which consumers can judge quality only after purchase) or goods purchased relatively infrequently. Many regulatory policies address problems of information scarcity and asymmetry. Consider truth-in-labeling regulations, which require that firms disclose the ingredients of their products. Certainly, there are cases—such as pharmaceuticals—in which consumers simply lack the expertise to understand the value of the ingredients. The Food and Drug Administration (FDA) approves pharma-

ceuticals, and this approval certifies that the chemical agent will perform as promised and that known side effects have been disclosed. Consumer protection is examined in some detail in Chapter 9.

Transaction costs. Transaction costs are best defined as "the costs associated with the transfer, capture, and protection of property rights" (Barzel 1989: 2). Stated another way, transaction costs include the costs of determining the price of a good, negotiating the exchange of the good, and monitoring to ensure that both sides live up to the terms of the transaction (Wittman 1995). These costs are not associated with production and thus are not incorporated into the price. Rather, they reflect the uncertainty that may accompany more complex products. If transaction costs are too high, otherwise desirable transactions may not occur. Regulatory policy may provide some means of reducing these costs. As Chapter 5 will reveal, banking regulations have reduced the transaction costs in financial markets by requiring that financial intermediaries meet prespecified capitalization and reserve requirements. The provision of deposit insurance further reduces transaction costs. Consumer protection regulations (Chapter 9) also reduce transaction costs by assigning liability for defective and hazardous products.

* * *

Much of what we refer to as *regulation* can be explained analytically as a response to market failure. Yet there are several problems with the market-failure explanation. First, market failure is often introduced ex post as a means of separating "good" from "bad" regulations. Explicit arguments concerning market failure are rare in the debates leading up to new regulatory initiatives; when they occur, they are usually combined with arguments that have distinct social and political dimensions. Yet one routinely discovers arguments concerning market failure in debates over the appropriate limits of governmental authority. As W. Kip Viscusi, John Vernon, and Joseph Harrington note, "Ideally, the purpose of antitrust and regulation policies is to foster improvements judged in efficiency terms. We should move closer to the perfectly competitive ideal than we would have in the absence of this type of intervention" (1995: 10). The underlying assumption is that markets must be assigned a primary role and the state must enter them only when it can facilitate their functioning. "The role of government," in the words of Milton Friedman, "is to do something that the market cannot do for itself" (1962: 27). While there is no reason, on the face of things, to assume that the market will be the institution of choice, market-failure arguments essentially raise the market to the status of a benchmark.

Second, if we are to take the question of market failure seriously, we must recognize that there is probably a good balance between regulatory

policies that mitigate market failure and policies that exacerbate it. Occupational regulations commonly impose great barriers to entry in professions characterized by low levels of complexity (e.g., barbers, taxi drivers), thereby allowing established actors to claim monopoly rents. Many economic regulations were designed to circumvent markets by establishing barriers to entry and exit and guaranteeing higher levels of profitability than might exist under a competitive market. Indeed, many critics of regulation have concluded that regulatory policies have been used to aggrandize established industry actors at a high cost to consumers.

Regulation and Cartel Management

Despite the common reference to market failure, regulations have often been used to circumvent market forces. According to George Stigler's classic article "The Theory of Economic Regulation" (1971), regulations are designed and operated for the benefit of the regulated parties. Industries may seek direct subsidies, controls over entry and exit, policies that affect substitutes and complements as a means of protecting or expanding the market for their goods, and authority to engage in some form of price-fixing. Stigler argues that the creation of barriers to entry is the most important form of policy sought by regulated firms, because such barriers can allow a de facto cartel to exist under the authority of the government, particularly when combined with some of the above-mentioned policies. The conclusion that regulations are designed to benefit the regulated parties may appear odd at first blush. Many major pieces of regulatory legislation charge the agencies in question to regulate "in the public interest." How, then, is it possible that behind this justification exists a set of policies that increases the wealth of the regulated and forces the population to absorb deadweight monopoly loss and higher taxes? According to Stigler, because costs are diffuse and information is scarce, uninterested voters lack the incentive to hold their representatives accountable. Moreover, legislators receive political and material rewards from the regulated, who, in essence, purchase the support of the state.

Stigler's economic interpretation was extended through the efforts of Richard Posner (1974) and Sam Peltzman (1976). According to Posner, many regulations did not simply emerge as the products of industry efforts, but reflect the interests of coalitions consisting of the regulated parties and key customer groups. Both have their demands reflected in regulations, with the costs forced on to the unorganized. Peltzman, on the other hand, interprets Stigler's theory as being "ultimately a theory of the optimum size of effective political coalitions" (1976: 212). For Peltzman, there are diminishing returns associated with both group size and wealth transfers in politics. After a point, larger political coalitions are counterproductive (since they

reduce the per capita transfer of wealth), and larger wealth transfers provoke public opposition that is difficult to overcome. Regulation concentrates potential benefits among a small group of firms, while the costs are diffuse and borne by an unorganized electorate.

The key methodological assumptions of the economic theory of regulation have been widely adopted among "public choice" scholars. We will examine the difficulties with these methodological and modeling decisions in Chapter 2. For now, it is important to note that, whereas the economic theories of regulation would seem to have some value in explaining key economic regulations, they have little to say about the social regulations that have dominated regulation since the late 1960s. Social regulations impose large costs on the regulated parties and provide diffuse benefits for the public at large. While the public may have few incentives to mobilize on behalf of regulation, the regulated certainly have little to gain and much to lose from the implementation of social regulations. Thus the cartel maintenance so central to the economic theories of regulation may be increasingly irrelevant, particularly following the competitive deregulation of the past two decades (see Derthick and Quirk 1985).

Regulation and Capture Theory

The key insights of the economic theory of regulation were recognized by early analyses of the regulatory state (see, e.g., Herring 1936). Beginning in the 1950s, a number of analysts began arguing that a variety of factors contributed to this state of affairs. In *Regulating Business by Independent Commission,* Marver Bernstein (1955) noted that regulatory commissions tended to move through a life cycle of types. After the energy of gestation and youth is expended, the commission enters a stage of maturity: it "becomes more concerned with the general health of the industry and tries to prevent changes which adversely affect it. Cut off from the mainstream of political life, the commission's standards are determined in light of the desires of the industry affected" (1955: 87). By the time it enters old age, the commission simply strives to maintain the status quo. Samuel Huntington (1952) arrived at similar conclusions with respect to the Interstate Commerce Commission (ICC). Agricultural shipping interests (especially farmers) had been successful in shaping ICC rate making. However, when this core constituency lost political power during the first decades of the twentieth century and railroad regulation declined in salience, the ICC had to turn to the regulated interests themselves for support. The result was the Transportation Act of 1920, which directed the ICC to enforce *minimum* rates designed to guarantee industry profitability. The ICC had been captured and would spend the next half century as a moribund agency guarding railroad profitability.

While regulatory capture was presented by many as resulting from the decline of the original constituency, others argued that this interpretation was far too charitable. Gabriel Kolko (1963, 1965), a revisionist historian, provided a wealth of evidence to support his contention that representatives of the regulated industries commonly played a central role in drafting regulatory legislation. Governmental authority was used to manage industries, thereby reducing the problems of overproduction and "ruinous competition" that might undermine profitability. It also obviated the need for state-level regulations that were often more radical and could have significant negative effects on the regulated industries. The use of regulation to protect industry reflects the contention that advanced capitalism requires a far greater integration of the state and economy than is often supposed by free market advocates (see McConnell 1966; Lindblom 1977).

Of course, the same criticism raised in response to the economic theory of regulation is applicable to capture theory. Although capture may have been commonplace in many economic regulatory agencies, there is little evidence that capture is possible in an age of social regulation (Meier 1988: 21–25; see also Worsham 1997). The new social regulatory agencies enforce economy-wide mandates and impose heavy costs. Moreover, the policy process in these agencies affords advocacy groups multiple veto points and expands access to the courts (see Stewart 1975; Eisner 2000: 118–133). As a result, capture is no longer much of a threat. Instead, the regulated parties have powerful incentives to reduce regulatory autonomy, embroil agencies in lengthy appeals, and force regulators to justify their decisions using market criteria.

Regulation and Sectionalism

The explanations presented above make note of the economic benefits of regulation, either in the abstract (i.e., in relation to their impact on issues of market failure) or as they accrue to individual firms and industries. However, some scholars have sought to discover the extent to which major regulatory initiatives have reflected the competition among regional political economies. Richard Bensel (1984) and Elizabeth Sanders (1986, 1987) have been the primary contributors to this line of inquiry. Sanders (1987) identifies distinct regional trading areas and examines the voting behavior of representatives on key regulatory initiatives. Building on Immanuel Wallerstein's world systems theory, Sanders focuses on competition between an industrial "core" and a "periphery" to reveal that many key initiatives have been attempts to use policies to prevent the shift of economic power across trading areas. For example, early antitrust legislation received a far greater level of support from the representatives of the agrarian periphery than from those of the industrial core of the Northeast (see Sanders 1986).

Given the limited relevance of some of the economic explanations to the new social regulation, the applicability of the regional political economy perspective is particularly noteworthy. The provisions of the 1977 Clean Air Act amendments are especially revealing in this regard. First, a coalition of eastern coal mine operators, coal miners, and environmentalists succeeded in preventing coal-fired power plants from meeting air quality guidelines by shifting from high-sulfur eastern coal to lower-sulfur western coal, even though this would have improved air quality more than the technological pollution control requirements that were eventually adopted. Second, by adopting a "prevention of significant deterioration" standard that allowed little additional air pollution (and thus industrial development) in relatively clean areas, the act reduced the incentives for firms to relocate from the industrial Midwest and Northeast to the relatively less developed South and West (Ackerman and Hassler 1981). In short, both elements of the 1977 legislation protected the interests of the industrial core and handicapped the development of the periphery.

The applicability of the regional political economy approach is not limited to environmental regulation. In explaining the new social regulations of the 1970s, Sanders's analysis of roll-call votes on key amendments to regulatory legislation shows that representatives from the core voted routinely to impose more stringent regulatory standards and impede the diminution of standards, whereas the periphery sought to minimize regulatory burdens. As Sanders explains: "The deindustrializing regions perceived in regulatory law a means of slowing economic decline by raising the costs of capitalization in the periphery, insulating the national economic from international economic forces, undoing the 'artificial' decentralization of the economy promoted by the periphery, and divesting the corporate powerhouses that had emerged out of periphery industries" (1987: 131).

Policy Choices in Regulatory Politics

Regulators have at their disposal a veritable arsenal of policy tools that vary tremendously with respect to the degree to which they replace market mechanisms, impinge on business decisions, and impose costs on regulated industries. In this section, we discuss nine of the most common regulatory policy tools: prohibitions; licensing; price, rate, and quantity restrictions; product standards; technical production standards; performance standards; subsidies; information provision; and assigning property rights and liability.

Perhaps the strongest policy tool available to regulators is the ability to introduce legal *prohibitions.* For example, the EPA has banned the production and use of several pesticides, including DDT and Aldicarb. Other product prohibitions include sales of automobiles without catalytic converters,

the sale or purchase of human organs, and the manufacture, sale, or purchase of certain narcotics. In a similar vein, current US regulatory policy prohibits the practice of trading stocks and commodity futures based on insider information and monopolistic practices on the part of businesses.

Regulators may also establish a system of *licensing* or *certification* to control entry and guarantee that all actors meet standards deemed necessary to achieve desired regulatory goals. In banking, for example, regulators have required that financial institutions meet specific capitalization and reserve requirements. Similarly, nuclear power plants must demonstrate a need for additional electric generating capacity and are required to meet certain safety standards before they can receive a government operating license. Licensing systems are not only used in highly technical areas, but are also extended to everything from cosmetology to tree surgery.

Governments have a long history of using *price, rate, and quantity regulation.* They use policy to regulate the prices charged for goods and services, the quantities of these items, and their flow to market. Price controls and rate-setting have been essential components of passenger airline regulation, interstate trucking regulation, long-distance telephone service regulation, banking regulation, and all interstate sales of oil, natural gas, and electricity. Federal regulators set prices and rates on the assumption either that a lack of market competition would result in excessive profits and suboptimal levels of production or that excessive competition could lead the regulated to trade safety for market share. Controls on the quantity of goods produced are common in the area of agricultural products and natural resources. Through marketing orders and production quotas, for example, the US Department of Agriculture (USDA) limits the amount of tobacco, citrus fruit, fresh milk, and other commodities that can be sold in interstate commerce, while the Department of Energy (DOE)—and its precursors—limited for decades the importation and production of various fuels.

Officials may establish and enforce *product quality standards* in hopes of achieving product safety and effectiveness. Food and drug regulation and consumer protection have relied extensively on such standards. For example, the USDA enforces quality standards that ensure a safe food supply, and the FDA requires that all drugs be demonstrated safe and effective before they can be sold in interstate commerce. Product quality standards are also applied to nonconsumable goods, such as the automobile safety standards established by the National Highway Traffic Safety Administration and the home appliance energy efficiency standards promulgated by the DOE.

Whereas product standards establish requirements for the quality and safety of products themselves, *technical production standards* establish requirements for the process by which certain goods are produced. Occupational safety and health policy and environmental protection policy

are two areas in which technical standards have been vital to the realization of policy goals. In the former, employers are required to install certain safety devices and provide a certain level of safety training to employees in order to reduce workplace injury and death rates. In the latter, companies are required to install equipment that reduces the pollution released into the environment. In both cases, technical production standards change the process by which goods are produced. These standards are often referred to as *command and control* regulations, since they command firms to meet a certain regulatory goal and control how they reach this goal.

More recently, regulators have begun to experiment with *performance standards* as a tool of regulation. Under performance standards, regulators may establish regulatory goals (e.g., a certain reduction in workplace accidents or pollution emissions) and delegate to regulated parties the task of finding the most cost-effective means of realizing these goals. The assumption here is that firms will be able to meet regulatory goals at a lower cost, because they have the best knowledge of the technologies they apply in the production process and the incentive to minimize costs. Performance standards have been used in recent years in environmental policy as regulators have sought to use incentives rather than command and control policies to reduce air pollution.

Another common regulatory tool is the use of *subsidies.* When employing subsidies, government officials reimburse firms for a portion of their costs or pay these costs themselves. Officials dole out these subsidies to ensure the production of certain goods or services that might not occur under normal market conditions. Subsidies may be direct, as when the USDA pays farmers to leave land fallow or when the DOE pays the costs of enriching uranium fuel for nuclear power plants. Subsidies may also be indirect, as when government regulators allow companies to charge higher prices for long-distance phone service in an effort to keep down the costs of local telephone service (generally referred to as a *cross-subsidy*).

As noted above, information scarcity is a common justification for regulation. One of the least-intrusive tools available to regulators is aimed at remedying this market failure—the *provision of information* to consumers. The government itself may provide information to consumers at little or no cost, as with the Department of Commerce's consumer information pamphlets. More commonly, however, regulators require firms to provide information to consumers directly, through product information statements and through truth-in-labeling laws. Implicit in the decision to rely on information provision rather than product standards is the belief that there is and should be a market for low-price/low-quality goods and services.

The least-intrusive policy tool available to regulators is *assigning property rights and liability* for the harm caused by defective or dangerous products. According to many scholars, most market failures could be remedied

by establishing clear property rights and liability standards that would facilitate the use of tort and contract law. For example, if an individual is harmed by the actions of a firm, a defective product, or a faithless contractual partner, he may seek compensation through the courts. In this way, bad corporate actors will be driven from the market, obviating the need for additional regulatory actions by government. While this regulatory tool is seldom used by itself, it is an important component of the regulatory toolbox in areas such as consumer protection, occupational safety and health, environmental protection, and increasingly, financial and securities regulation.

The Relationship Between Regulatory Justifications and Tools

Although it is common to speak of regulatory tools as if they are mutually exclusive, there is in reality much overlap. For instance, a quantity restriction of zero is, for all intents and purposes, a prohibition. Similarly, licensing and certification programs are also a type of indirect information provision, since, for example, USDA inspection and grade certifications provide consumers with information regarding the quality and healthfulness of food. Regulatory tools, in fact, are similar to other tools in that different ones may be used to accomplish the same task. Just as pliers, a crescent wrench, and a pneumatic socket driver can all be used to turn a bolt, a subsidy, a technical production standard, and a performance standard can all be used to protect the health and safety of workers.

Different regulatory tools are best suited to certain tasks. Indeed, there is a close connection between the reasons for regulation and the appropriateness of regulatory tools. Subsidies, for example, are a poor choice for dealing with negative externalities. Paying firms to reduce their pollution may encourage some firms to actually employ *more* polluting production processes. If the subsidies for pollution reduction are high enough, they may provide an incentive for additional firms to enter the market, thereby contributing to overproduction. Similarly, assigning liability and relying on tort law are poor choices for protecting financial investors, since when these investors are entitled to seek compensation for fraud or mismanagement, the financial entity responsible for the damages will often be bankrupt. In fact, assigning property rights and liability is a poor choice of regulatory tools whenever the damages suffered by consumers or other firms cannot be easily reversed (e.g., death or debilitating injury).

Finally, technological and social changes often affect both the justifications given for regulation and the appropriate regulatory tools. Consider the situation of telecommunications. For decades, long-distance telephone service was considered a natural monopoly: the federal government set the rates for American Telephone and Telegraph (AT&T). Improvements in computer

and fiber-optic technology, however, opened up the possibility of competition for long-distance service while undermining claims of natural monopoly. In response, in the 1980s, the federal government deregulated long-distance telephone rates (see Chapter 6). We see something very similar occurring today in the area of electricity generation. Improvements in technology have made retail competition for electricity feasible, and soon both wholesale and retail purchasers of electricity will be able to choose their supplier of this commodity, replacing price and rate regulation with competition (see Chapter 10). In a different area, vast improvements in monitoring and remote sensing technology have made measuring levels of pollution much easier and more accurate. These advances have allowed for performance standards in pollution control that require the heretofore unavailable ability to continuously and instantaneously measure pollution emissions.

Deregulation as a Policy Tool

Deregulation—the process of reducing or eliminating government regulations—has been one of the most visible and forcefully articulated elements of the contemporary regulatory debates. Advocates of deregulation provide three general justifications for deregulation. First, even if regulations often stem from honorable motivations (e.g., to protect the public interest or to compensate for market failure), they have unexpected and pernicious effects once put into practice. Second, other observers—on both the right and the left—criticize regulations on political grounds, arguing that they are used to reward political allies and entrenched industrial interests. Finally, other scholars believe that any attempt by government to solve social or economic problems will produce suboptimal results when compared with the free market (see Wittman 1995).

While its most zealous advocates promote deregulation as a cure-all for many economic problems, it is more productive (and more accurate) to view deregulation as simply another regulatory tool, which is better suited to some problems than to others. For example, the deregulation of long-distance telephone rates and airline ticket prices in the 1970s and 1980s was wholly appropriate, given the crumbling natural monopolies in these areas. On the other hand, deregulation (and increased competition) is less appropriate as a remedy for negative externalities. It is important to recognize that deregulation does not always mean moving from regulation to no regulation. Often, deregulation simply involves replacing one tool of regulation with another, less intrusive tool. Consider, for example, recent changes in the regulation of flammability in infant sleepwear. Rather than meeting a government-mandated level of flame resistance, manufacturers now simply provide labels that identify the flame-resistant nature of the garment (i.e., product standards have been replaced with information provision). Even

when an industry experiences complete deregulation in one area (e.g., airline ticket prices), regulation continues in other areas (e.g., airline safety and maintenance standards). In thinking about deregulation, then, we have to evaluate it as we would any other policy tool: Is it appropriate for addressing the problem at hand?

Since the mid-1990s, deregulation as a policy tool has been superseded by a related phenomenon: a greater reliance on public-private partnerships and voluntary initiatives. During the Clinton presidency, the creation of partnerships was part of a larger effort to reinvent government (or REGO) by applying lessons gleaned from corporate America. The core idea was to make government more flexible, responsive, and results-oriented (see Osborne and Gaebler 1992). As part of REGO, regulators created a dense network of partnerships designed to promote public-private collaboration and experimentation, with the hope that the lessons learned could be used to future regulatory goals. In some cases, partnerships complemented policy and were effectively integrated into a larger regulatory structure. In other cases, they existed in a tense relationship with existing bureaucratic structures and policy instruments (see Fiorino 1999). However, during the presidency of George W. Bush, there is much to suggest that partnerships and voluntary initiatives have been viewed as a substitute for policy rather than a complement, making them deregulation in new clothing. The case studies in this book will provide several opportunities to explore the growing role of partnerships.

Conclusion

The question "Why regulate?" has multiple answers, some more satisfactory than others. Competing explanations posit that regulation is a response to the demands articulated by elected officials (e.g., public interest theory, sectional political-economic competition), powerful interests (e.g., the economic theory of regulation, capture theory), or the environment (e.g., failing markets). Each explanation has dominated the study of regulation during different periods: the public interest rationale prior to World War II and during the 1960s; the economic theory of regulation and capture theory in the 1960s and 1970s; and the public choice interpretation of regulatory policy as the product of influence and rent-seeking elected officials in the 1980s and 1990s. None of these explanations can account for regulatory policy choices in all areas. The most obvious problem is the fact that the regulatory bureaucracy is de-emphasized or neglected altogether. Regulatory bureaucracies, however, are an important element in the process of regulatory decisionmaking. If public policy is defined as patterns of governmental action, we cannot be content with restricting our focus to exogenous

demands for policy, but must also consider factors that are internal to the bureaucracy. Moreover, we must situate regulation in the larger political-institutional network of relationships, seeking to understand how relationships with the president, Congress, the courts, other regulatory and nonregulatory agencies, and state-level implementers shape the patterns of governmental action.

In Chapter 2, we examine in more detail three of the most common theoretical explanations for regulatory policy change: the bureaucratic politics perspective, which posits that most of the forces generating changes stem from forces within the bureaucracy; the subsystems perspective, which focuses on coalitions linking institutional actors and affected interests; and the principal-agent perspective, which emphasizes the relationships between vote-maximizing elected officials and their budget-maximizing bureaucratic agents. We explore the conditions under which each explanation of regulatory policy is likely to be most accurate, grounding this discussion in the concepts of complexity, salience, and bureaucratic leadership. In successive chapters, we discuss recent developments in several regulatory areas, evaluating these developments through each of the three theoretical lenses.