

I. Introduction

A. Earlier this year, particularly in spring to summer, there looked to be a major sea change developing in the general market regulatory regimes. However the push for improved regulation has died down or been subsumed by other pressures. As well as what appears to be some very clever political maneuvering.

1. Part of the decreased interest lies in everybody being overwhelmed by the magnitudes and quantities of the shocks and malfeasance. People appear to simply be too tired to continue to pursue things.

2. Another part of it has to do with the still-born attempts are 're-regulation'. For example the Oxley-Sarbanes bill, the SEC reform, the Accounting Standards board, and Spitzer's efforts. Most of these are rapidly amounting to little or less.

a) The O-S Bill got thru but over-emphasized written regulations are the expense of workable controls. Classic response of write another rule and they'll follow it. And what little effect it might have had has been diluted by the level of resources and support it's getting. A great irony of Congress writing yet another bill is that it was Congressional inattention, or going along with the industries in question, that led to these problems in the first place.

b) SEC reform appears to be still-born with the departure of whatshisname plus more tellingly the under-funding and collapse of staff morale. More importantly, even as the purported scope and scale of responsibilities has/was increased, all throughout the 90s the resources made available were decreased.

c) Similarly the notion of an independent well-funded Acct. Standards board also appears to have gone by the board.

d) And however noble most of Mr. Spitzer's efforts are structurally cosmetic. They don't address either the magnitude of the malfeasance and/or the in-built incentives for Wall St to do what it does.

B. However the roots of the changes in regulation go back much farther.

1. Most of the major efforts, e.g. Telecom, Energy, Accounting, the split between banking and finance, that have 'failed' so miserably this last two years can be traced back to legislative efforts in the early to mid-90s.

a) And many of the legislators now clamoring for new reforms were part of the charge then. And so benefited.

2. Much of the impetus for further de-regulation are rooted in a belief in the efficacy of pure markets that were and are part and parcel of the ideology of the 'anti-government' revolts of the 80s.

a) Yet another example of pendulum swings. As more and more taxes were collected and appeared to do less and less the need to reduce the size of government was increased. As a result we've hamstrung fiscal policy. But then, at the time, some cutbacks were required. We tested to it's limits the concept that blind government spending would lead to major changes contrary to the way things actually worked.

b) As the pendulum has swung back however we've potentially thrown the baby out with the bath water because certain kinds of regulation are essential, e.g. legal systems and private property. And very few modern markets and industries are in fact purely competitive; rather their structures are such as to require some regulation, e.g. monopolies and/or oligopolies. And there is also the issue of public welfare thru standards, e.g. pollution, etc.

C. Having thrown the baby out with the bathwater we have two sets of economic problems.

1. First, in the short-run the level of trust and credibility in large enterprises is extremely low. As a result the willingness of the market, i.e. the majority of investors, to get back in is going to depend on the quality of their earnings; and if they continue to think the books will be cooked they will continue to be reluctant.

2. Second, we've now tested the limits of regulatory regimes on the other side and found them wanting. So the question is what level of regulation is required for different situations and what's the best mechanism for achieving our goals.

a) The first part of this 'assertion' implies a much more nuanced analysis and set of policy choices than appears to play well and/or to be get thru the legislative process.

b) And that works with the second, which is that written rules enforced by legalistic mechanisms don't work well in many circumstances.

c) Hence we're on a search for broad legislative charters that set policy goals and external structural regimes combined with quasi-market mechanisms that create self-enforcing incentives for market actors to behave themselves.

II. Nature of Regulation & Market Structure

A. Types of Environment Structure

- 1. There are certain public goods, i.e. those things we can all share in like defense, legal institutions, etc. that aren't often analyzed that are necessary for the effective function of society and only a government can provide well.**
- 2. There are others that are more traditional public goods, e.g. public health, where there are both private and public benefits but many of the benefits accrue over such a broad range while the costs are narrow that a public regime is most appropriate too.**
- 3. Another class of goods is behavioral regulation to ensure that the private and public good, or outcomes, in particular markets are aligned. Many markets are natural monopolies and/or oligopolies because of the nature of their structures and technologies. These sorts of markets don't necessarily generate ideal outcomes; and certainly don't generate purely competitive ones. Classic examples are public utilities, telecommunications, and energy.**
- 4. And the final category of potential public goods are those where outcome standards, e.g. environmental quality, are being set.**

B. Public & Private Alignment

- 1. In the first two cases these are the classic public goods categories and are pretty clearly the domain of normal government activity; and have been for literally thousands of years.**
- 2. Behavioral regulation is an outgrowth of the emergence of large enterprises at the end of the 19th century. As is the associated regulatory board.**
 - a) The creation of anti-monopoly regulations was driven by the well-founded perception that large enterprises were serving private interests by exploiting public advantage, e.g. railroad's monopoly pricing power and excess charges in local markets.
 - b) But what's turned out to be true as these inter-twined actors evolved is that the rents that accrued to the regulated parties by managing the regulators were such that investing in controlling the latter's behavior made good economic sense. It's this mechanism that explains much of the regulatory change in the 90s in telecomm, energy, etc.
- 3. Social goals and standard setting have a long history, e.g. debates over education and public health, but really grew up in the 60s as we became a much wealthier society. However, with the best of intent, we found that**

bureaucratic regulation didn't tend to lead to the best outcomes. And it was expensive and mis-directed as well.

- a) Over time the same sort of capture mechanisms tended to evolve, e.g. the auto industry and gas mileage standards.
- b) A great irony of all this is that however hard various industries fought against various standards that over time they tended to increase their competitiveness and profitability.

C. Purposes of Regulation

1. The fundamental purpose of regulation and government intervention ought to be to improve the efficacy (defined as the closeness to desired outcome) and efficiency (defined as the minimal direct and in-direct use of resources [thereby implying & including the notions of avoiding distortions] to achieve these goals) of both market operations and the provision of public goods.

2. The keys here are to find goals that are achievable and to find the appropriate mechanisms for achieving them.

- a) As part of this effort most markets are not 'pure' and in an un-regulated state will not necessarily achieve either their own best outcome, or performance, nor will they align with the proper balance between public and private good.
- b) Alignment between public and private good doesn't mean the elimination of all externalities but rather taking them into account as goals are balanced.
- c) In any case all markets require some public goods to function, e.g. legal institutions, notions of property, enforcement, defense, etc.

3. At the same time many regulatory mechanisms themselves aren't very effective, e.g. the capture-effect where rule-setting boards finding themselves being influenced by the industries they regulate.

- a) This is a specific example of the broader economic incentive for organizations and enterprises to get the legal and regulatory environment to work in their favor.

III. Future of Regulation

A. Much, if not most, of the de-regulatory impetus of the 90s has failed the test of private efficiency and public effectiveness.

1. Telecomm – market is going back to what it was driven by both fundamental economies of scale and the fact that regulation was never enforced where it counted.

a) Even with ostensible de-regulation the local Bell operating companies succeeded in preventing the entry of local competitors thru operating barriers. By continuing to control local access they prevented anybody from effectively competing with them.

2. Energy – the efforts of Enron to de-regulate energy are pretty well-known. Had several problems:

a) First, not clear anybody still understands market structure and realities of de-regulation. It appears that power and other utilities are natural local monopolies so one has the same structural problem here as in telecom.

b) Next by separating the power generation from the distribution and local delivery and de-regulating it but not the other parts of the market incentives were created to mis-align things. Be interesting to see if somebody does the investigation and work to really look at this.

c) Finally the financial deregulation that allowed all the speculative instruments to be created, combined with the distortions from a) & b), created strong incentives and opportunities to manipulate the markets.

3. Finance – it turns out the old split between financing and banking had a lot going for it. The number of investment houses who mis-lead investors to get banking business is enormous.

a) Beneath all this, and bear in mind much of the M&A activity in these markets, e.g. Citigroup, didn't make a lot of sense without regulatory regime change the same set of bad incentive structures were in place.

4. Accounting – same difference. Too much business available to accountants.

B. Those are examples of market de-regulatory failures brought about by the momentum of anti-government & anti-regulation built up over the 90s. At the same time we don't have the mirror image of regulatory successes, e.g. in managing pollution, auto mileage or safety standards, etc.

C. Finally there is the question of making major policy initiatives effective, which is broader and deeper.

1. Healthcare

2. Welfare Reform

3. Education

D. In all these cases there seem to be some common causes for failure as well as idiosyncrasies based on the nature of the problem.

- 1. For market regulation there seems to be a combination of rule-based legal controls not being effective, lack of understanding and appropriate alignment with the market structure and incentives to 'cheat'.**
- 2. For standards management there seems to be a combination of rules again being an ineffective mechanism, bureaucracies being both cumbersome and ineffective as well as developing their own agendas and of course the management of legislation by interested parties.**

E. The situation is less clear with major policy initiatives because of their size and complexity.

1. First is the issue of doing anything at all and what the goals are. Given that we prefer not to let our fellow citizens freeze in the dark, die in the streets or remain ignorant and dangerous however then it becomes not just a question of policy but mechanism.

2. At the same time for these larger questions they become inter-twined with other policy goals, often to their detriment.

a) A lot of the deterioration of education lies in asking the educational system to supplement or replace other social institutions such as family, community and church that are no longer sufficient to the effective socialization of our young.

b) Other problems lie in placing direct burdens, e.g. the inner conversations with educators that point out that de-segregation led to a dumbing down of all education

c) And a third force is the extent to which education at all levels has been extended to larger and larger portions of the population.

d) A particularly interesting phenomenon since future economic and social prosperity will require higher levels of education.

3. What is clear is that each of these initiative areas deserves its own analysis set also requires being set in the larger context of social policies to avoid contradictions and un-intended consequences.

4. And at the same time there are general mechanisms that should serve as templates in all these cases.

IV. Goals & Mechanisms

A. The goals of regulation should be set to manage the trade-offs between desirable outcomes versus inadequate mechanisms. In other words if an effective mechanism isn't available the distortions resulting from an ineffective one should be allowed for the in the goals setting.

1. This includes the tendency of many regulatory regimes to be captured by the regulatory parties.

B. A 2nd Rule of Thumb would be that market-like mechanisms will tend to be both more efficient and effective.

1. Setting up psuedo-markets for such things as air pollution rights has proven to be extremely effective and efficient, takes advantage of the efficiencies of market-lie mechanisms and also allows and encourages the adaptability of private action rather than the rigidities of rule-setting.
2. However it's not clear that this is entirely a simple rule-of-thumb; e.g. the privatization of such things as police and fire protection isn't simple and all too often ideological discussions miss the major public good aspects of these. For example why did the firemen at the WTC go back into the WTC ?
3. So establishing a balancing mechanism and proper balance of rules and mechanisms is going to be a case-by-case and market-by-market effort.

C. All of that said in many of the market regulatory debates that should have taken place, e.g. accounting, telecom, etc. rules-setting regimes are not the best mechanism.

1. Interestingly enough for the recent multiple examples of corporate malfeasance that none of the 'free-market' advocates suggested market-like mechanisms. Only one NYT editorial raised the concept of corporate insurance to privatize the external costs.
 - a) And to the argument that this was a temporary aberration the size, number and so forth of the mis-behaviors was and is such that it's got to be considered somewhat systemic.
 - b) There are two paradoxes here and have to do with the self-correcting nature of the markets, at least so-argued. It's not in the interests of the good companies who are accurate and conservative in their management and controls to have the bad ones ruin the market for them. IT IS ALSO not in the interests of the major public investors yet none of the major funds or pension plans appears to be taking a role in improving things.
 - c) At the same time, and based on my experience, it is in the personal interests of good management teams to have accurate, timely and effective controls. Bad accounting is a symptom of either terrible management or a breach of fiduciary responsibilities. Good management wants simple and effective controls.

d) A certification and insurance program with non-performance bonds sold and traded on open markets would appear to be a mechanism that would fix a lot of the malfeasance problems.

2. Market structure regulation is a more complex problem and therefore needs more study.

a) That said clearly de-regulation of many of the major industries, e.g. telecomm, energy and finance was not well studied or thought out. So even on the policy level what seems to have happened is that in the general anti-gov't & anti-regulatory environment that major industry players dictated a lot of the agendas and outcomes. Both with the regulatory agencies and Congress.

b) But again this looks like a fertile area for new mechanisms. For example market access rights could be created and licenses on a renewable basis with the proceeds used to fund regulatory agencies and monitoring capabilities. Then license pricing could be partly set on the basis of divergence from outcomes mandated by policy.

(1) So for example where more competition was to be encouraged in telecomm the cost of license for new local entrants could be significantly lower while those for larger, entrenched players could be raised based on their levels of compliance with, say, open-access to local markets.

3. Performance standard setting is a good example though. In many cases, again for example air pollution standards, government regulation has in fact enhanced both the standard setting and competitiveness of the marketplaces.

a) In auto gas standards for example the original estimates of cost/car were not only exaggerated at the time but grossly underestimated the impact of the regulations on engineering and technology development. So original estimates of cost/car of many \$000s turned out to be a few \$00s instead.

b) It would seem that there are lot of public policy standards where the proper role of government would be not to set regulations but to mediate a workable solution by the key players involved.

(1) A really good example is gun control where the presence of automatic weapons on the street is demonstrably dangerous and anti-social yet at the same time one doesn't want to prevent private citizens from doing as they see fit. It would seem that a registration mechanisms and tracking & monitoring capability would go a long way and that both gun-control advocates as well as the gun-lobbies ought to be invited to participate in drafting the legislation and in designing the control mechanisms. In other words at the end-of-the-day put your money where your mouth is

D. Regulatory mechanisms for complex major policy initiatives like healthcare, social welfare, and education would be more difficult yet. Partly

because of the variety and diversity of different goals. But mostly because the bureaucracies that have grown up in these areas have themselves captured the policy-setting mechanisms. And also because of the more pure public good aspects.

1. Again that said the maintained hypothesis looks to be that rules-based regulation is inefficient and cumbersome. And that some sort of alternative market-like mechanism that complements or supplements rules-based goal setting might be appropriate.

a) This wouldn't preclude regulatory monitoring of compliance with outcomes goals as well as procedural restraints.

2. To take healthcare as an example an integrated program might

a) Establish levels of healthcare and establish goals for each level and then

b) 'guarantee' the bottom levels for all citizens

c) while providing outcomes based payments per procedure. These procedural payments could be set by the practioners initially subject to monitoring agency review with local adjustments.

d) Over-time tracking and monitoring outcomes in database and subsequent rules-based revision of the payments could be evolved.

e) The goal is not to entirely replace rules but to focus them where they're the most efficient mechanisms while supplementing them with other mechanisms more appropriate to the level of detail and information. And to create incentives for compliance rather than evasion.

3. Similarly for education a set of standards could be developed while leaving details of structure, curriculum, etc. in the hands of local organizations.

a) A key question here is how to ensure a focus on what's best for the children; i.e. too many examples of local ideology over-whelming good, balanced sense.

b) On the other hand there is a Darwinian mechanism at work here.

c) By then extending and mimicking some of the mechanisms from healthcare or other regulatory areas the door would be opened for private providers to contract for educational services in competition with local government providers.

d) One could see wide varieties of hybrid organizations evolving.

E. In all these cases there must be a balance between the public and private goods and between efficient means and effective outcomes.

1. From Fogel's analysis of history we can argue, in fact conclude, that two of the most important public initiatives have been education and public health. In other words while a good education clearly has private benefits

we all benefit economically and socially from an educated and competent populace. And from the revolutions in public health that made cities survivable places.