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**Does regulation fail or do we fail regulation? The paradox of imperfection<sup>1</sup>**

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*Abstract*

Regulation is rightly understood as an essential but imperfect institution. The perfect can be the enemy of the public good. The integral theory of markets, market failure, and economic regulation obscures a paradox: regulation can never be perfect in the second place because markets can never be perfect in the first place. Although regulation can be a substitutive and corrective policy instrument, it was never really meant to achieve what markets are meant to achieve. Regulation that would perfectly replicate the marketplace is not only impossible but undesirable, because the market itself is incapable of guiding economic exchange toward public purpose. Failures of the market must be addressed by political means. With the recent financial crisis, the counterfactual became factual to catastrophic effect. Markets failed, regulation failed, and deregulation failed. If there were ever a time to revisit the concepts of market and regulatory failure, it would seem to be now. Conceptual frameworks aid thinking about markets and regulation as imperfect institutions. Broadening the perspective of market failure to include structural, transactional, and distributional dimensions informs an understanding of regulation's immense challenge. Although the rationale for restructuring and deregulation often centers on nonmarket or regulatory failure, regulation may not fail in theory or practice as much as it is failed by us. Focusing primarily on the economic regulation of public utilities, the paper considers the concept of regulatory failure and how regulation is failed as a policy institution.

*Keywords*

Market failure, regulatory failure, institutional perspective, regulatory reform, regulatory capacity, and deregulation.

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## 1. Introduction

"Le mieux est l'ennemi du bien" (Voltaire, *La Béguéule*, 1772).

Economic regulation finds itself in a paradox of imperfection:<sup>2</sup> regulation can never be perfect because markets can never be perfect. There exists no absolute perfection to meet the eyes of all beholders. Dynamic markets never achieve the mythical equilibrium even at their best; they seek improvement in the social welfare. Regulators setting their sights on perfection in the form of equilibrium would be shooting for the proverbial moving target. Belief in perfect regulation implies belief in perfect markets and neither is conceivable, let alone knowable, in any natural or artificial state. That is, markets fail. Regulatory imperfection is a paradox because perfecting the inherently imperfect is impossible, as well as undesirable. Perfection in regulation may indeed be the enemy of the public good.

The paradox suggests that regulation was never actually meant to be perfect. Markets cannot yield perfection when nonmarket values are considered. Market failures that violate core values offend the public interest. If regulatory perfection means reproducing the perfectly competitive market, regulation is destined to disappoint because markets are destined to disappoint. Understanding regulation as a proxy or substitute for market competition is a used and useful heuristic. Doctrine and practice recognize regulation as imperfect but necessary in the case of monopoly, but to substitute is not necessarily to replicate. Regulation is also a responsive, corrective, and active policy instrument for addressing a broad array of market failures.

The paradox also suggests that principled regulation is imperfect not simply *of design* but *by design*. Regulation too will always fail. The public interest is no less elusive than the market equilibrium, and arguably far more so because it must be divined by democratic politics. Like markets, regulation seeks improvement rather than perfection. The quest is deliberately encumbered by social values and aspirations. Regulation does not simply acquiesce to the inevitability of imperfection, but embraces it as purposive. Regulation seeks a public interest that markets cannot.<sup>3</sup> Regulation wants more than markets have to give through processes that markets cannot provide. Perceived problems of process may actually be expressions of democracy and justice.<sup>4</sup> One person's barrier to efficiency is another's due process. Sacrifice by some is necessity to all. Regulation provides politically accountable means by which various market failures can be addressed. Perfection in either markets or regulation is relinquished willingly for the greater good.

Given the paradox of imperfection, the forced symmetry between market failure and regulatory failure is tenuous.<sup>5</sup> Regulation is perceived as heavily flawed, in part because it is juxtaposed

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<sup>2</sup> For regulatory paradoxes, see Cass R. Sunstein, "Paradoxes of the Regulatory State." *University of Chicago Law Review* 57:2 (1990): 407-441.

<sup>3</sup> For similar reasoning, see Anthony Ogus, *Regulation: Legal Form and Economic Theory* (Hart Publishing, 2004).

<sup>4</sup> On democracy and capitalism, see Robert B. Reich. *Supercapitalism: The Transformation of Business, Democracy, and Everyday Life* (2008).

<sup>5</sup> See, for example, Wolf's forced parallelism, where "internalities" describe regulatory failures associated with bureaucratic self-interest. Charles Wolf, Jr., *Markets or Governments: Choosing Between Imperfect Alternatives* (MIT Press, 1988).

against markets that are highly idealized. Minor market shortcomings are contrasted to major bureaucratic morasses. The role of politics is dismissed or disdained. The case for perfect regulation is never made, especially by those who practice it. All expectations of perfection are, of course, unrealistic. In a second-best world,<sup>6</sup> the imperfections of both markets and regulation and their consequences are well recognized by advocates and critics. Even still, markets and regulation are symmetrical in neither form nor purpose. What regulation is asked to do is harder than what markets are asked to do; the former must contend with the failures of the latter by balancing efficiency with equity. Markets cater and bend to individual interests, while regulation must consider the collective interest. Both markets and regulation have unintended consequences, but regulation has intended consequences as well. Markets are sensitive to regulatory failures, but regulators are hyper-sensitive to market failures because as stewards of the public interest, this is their charge. It is not that regulators dislike markets, competition, or efficiency, but that they want markets to work to the benefit of consumers, as well as producers.

In a final paradoxical twist, regulation may not fail as much as we fail regulation. The institution may suffer less from regulatory failure than a failure to regulate or to regulate well. Politics can legitimize regulation, but also disproportionately undermine and weaken it as an institution and play directly to the hands of self-interested adversaries. As long as regulation is failed, its theoretical prowess or practical worth cannot be known. Is regulation a bad theory or a good theory gone bad? Regulation's superiority over market failure cannot be proved and its efficacy as a policy instrument cannot be demonstrated. From an institutional and values perspective, and given the potential consequences, ineffectual governance cannot be a rationale for no governance. Erring on the side of imperfect regulation over imperfect markets is the prudent course. Nonetheless, imperfection is no excuse for inattention to how regulation can be failed, as explored in this paper.

## 2. Market Failure

Markets emerge from a brew of economic want and political will. Free markets are not free by desire or design.<sup>7</sup> Markets are an artifact of nonmarkets, owing to the political economy because they are allowed to exist under the legitimacy of the state. Market structures (eggs) may call for regulation (chickens) and regulation in turn will shape market structures. Rather ironically, structure and regulation are essential for "liberalized" markets.<sup>8</sup>

Economic exchange begets market structures and rules, which beget markets, which beget market failure, which begets regulation, which begets regulatory failure. Regulatory failure can beget regulatory reform or market reforms leading to changes in the rules that may result in failures of restructuring.<sup>9</sup> Regulation today plays a role in facilitating markets and providing

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<sup>6</sup> Alfred Kahn, *The Economics of Regulation: Principles and Institutions* (MIT Press, 1988).

<sup>7</sup> See Fred S. McChesney, "Rent Creation in the Economic Theory of Regulation," *Journal of Legal Studies* 16:1 (1987): 101-118.

<sup>8</sup> "The WB's Role in the Electric Power Sector," World Bank Policy Paper 1993, as cited in Ashley Brown, et al., "A Handbook For Evaluating Infrastructure Regulatory Systems, presented at the World Bank INFOSHOP, October 2, 2006.

<sup>9</sup> See Karl A. McDermott and Carl R. Peterson, "The Anatomy of Institutional and Organizational Failure," in *Obtaining the Best from Regulation and Competition*, edited by Michael A. Crew and Menahem Spiegel (Springer, 2006).

oversight when competition is workable but still imperfect. A market is “workable” only if market failures are manageable and tolerable. Workable markets are not inevitable but may stem from markets, self-regulation,<sup>10</sup> or regulation; each path can be traced back to structures that provide for rules of engagement, methods of conflict resolution, and systems of accountability. So goes the intricate dynamic interplay of imperfect markets and imperfect regulation, shown here as integrated system (Exhibit 1). The system, operating within the broader political economy, is actually more evolutionary and adaptive than is typically recognized.

Markets rely on diversity of endowments, preferences, and specialization, as well as production economies.<sup>11</sup> In their ideal and impossible form, markets are absent of:<sup>12</sup>

- Public or collective goods
- Positive or negative externalities associated with production or consumption
- Barriers to market entry or market exit
- Information asymmetry, distortion, or restraint
- Transaction costs for market participants
- Poorly defined property or other legal rights
- Market power to manipulate behavior or influence price

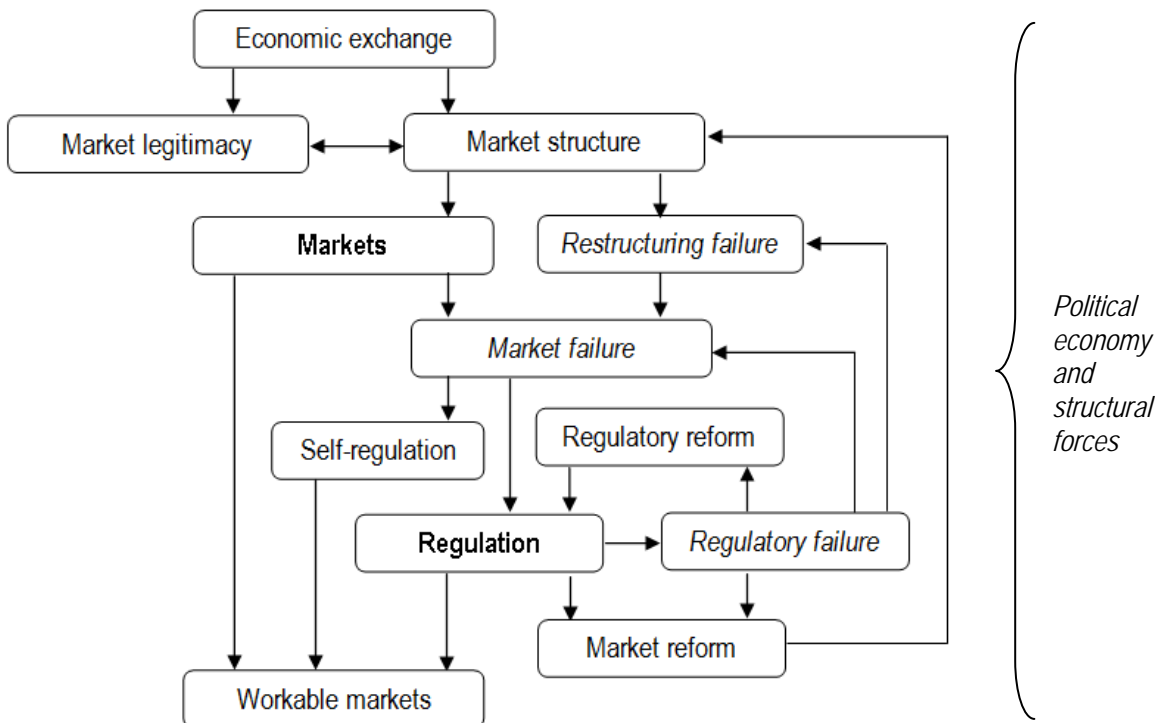


Exhibit 1. Markets, Failure, and Regulation (Author’s construct)

<sup>10</sup> The role of self-regulation merits more exploration but is beyond the scope of this paper. Suffice it to say, however, that self-regulation cannot be a substitute for regulation by the state when a market failure is of interest to the state.

<sup>11</sup> Michael C. Munger, *Analyzing Policy: Choices, Conflicts, and Practice* (W.W. Norton & Co., 2000).

<sup>12</sup> Ogus (2004) and Wolf (1988).

Perfectly competitive markets bring about decentralized economic activity, equilibrium of supply and demand, efficient prices that reflect costs, and technological and managerial innovation. As Schumpeter found, “Perfect competition is the exception... There cannot be many instances of it.”<sup>13</sup> Economic activities of all sorts may fail for all sorts of reasons. Business failures include the production of goods that are of poor quality, undesirable, or obsolete; ventures with a weak financial or marketing strategy; diversification without expertise; or other forms of corporate incompetence. Competitive markets by definition have winners and losers and business may fail while for practical purposes the market works. Firm bankruptcy is not a failure of competition but a failure to compete and a natural manifestation of the competitive process. Governmental policy can affect the likelihood or impact of failures but the state should not protect market players from themselves or their own lack of business acumen. U.S. antitrust law is thus designed to “protect competition, not competitors.”<sup>14</sup> Merger policies ideally help preserve a competitive field. Business bailouts in the market economy are supposed to be a rarity, justified only in broad public-interest terms. The extraordinary but selective interventions during the 2008-2009 global financial crisis may be the exception proving the rule of limited interference.

Regulation generally can be defined as an essential and authoritative institution for the intervention of the government in the economy with the purpose of influencing or correcting the behavior of individuals or entities in the context of a market failure in order to increase general welfare as defined by economic or social values. Economic regulation generally concentrates not on failures of business but failures of markets. Perceptions about market failure and appropriate response make for a salient intellectual schism. Now conventional economics, owing to the intellectual prowess of neoclassicism, the public-choice paradigm, and the University of Chicago nameplate, places its emphasis on a positive behavioral theory centering on private interest. Drawing heavily on the microeconomics of individual utility and social welfare, this perspective elevates allocative efficiency as the goal and standard by which virtually all exchange—economic and political—is judged. The rationality of producers, consumers, and politicians is assumed in the extreme and all manners of behavior are explained by rent-seeking and gaming in the relentless pursuit of self-interest. Unfettered markets are strongly favored and some imperfection is readily accepted. From this perspective, the criteria that constitute market failure are few and far between.<sup>15</sup> As discussed below, economic regulation is viewed critically, often cynically, with regard to execution and effectiveness.

By contrast, institutional economists and many political scientists advance a less cynical and often more normative theory centering on the public interest and the institutions entrusted with its keeping. Institutionalists view efficiency as a goal among others, including social equity. They concede the value of efficient means, as long as those means are directed toward desirable ends as shaped by social values and desirable outcomes. Institutionalists are comfortable broadening the criteria for market failure to consider the transactional and distributional dimensions of markets. From this perspective, market failure is not an isolated deviation but a propensity to deviate substantially and persistently from the competitive market archetype. Whereas business failures are idiosyncratic and incidental, market failures are regarded as

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<sup>13</sup> Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (Harper, 1942).

<sup>14</sup> *Brown Shoe Co., Inc. v. United States* 370 U.S. 294 (1962).

<sup>15</sup> Clifford Winston, *Government Failure versus Market Failure: Microeconomic Policy Research and Government Performance* (AIE Brookings, 2006).

endemic; corrective remedies must be designed accordingly and applied deliberately. Some market sectors—financial, insurance, and public utilities—seem especially failure prone. The need for economic regulation and its promise are defined more broadly. Institutionalists accept that both markets and regulation are inherently flawed, but prefer to place their bets on the side of imperfect regulation. Regulation “in the public interest” is the institutionalist mantra, despite a tacit acceptance of its idealistic and elusive nature.

In keeping with the institutionalist tradition of a more expansive treatment of market failure, a heuristic and non-exclusive typology is synthesized here. Its purpose has less to do with the failure of markets than the challenge of regulatory governance. To some degree, the diagnosis of market failure can be clinical, making use of the tools of forensic economics to show, for example, abuses of market power. But a multitude of failures touch upon values, which in turn are shaped by ideological and partisan persuasions. Although objective analysis can inform the understanding of market failures, their ultimate disposition is the stuff of political institutions. Perception is also as relevant as an objective measure of failure. Whether failure is perceived or perceived to be relevant may be a matter of perspective in some cases. In others, prevalent social institutions define accepted market behaviors and outcomes. Three broad categories of failure presented here are structural, transactional, and distributional.<sup>16</sup>

First-order failures are largely *structural* and apparent even prior to economic exchange. The market is *ineffective* and the competitive outcomes are thus *unsustainable*. For practical purposes, the market is not workable. An obvious first-order failure of a very fundamental nature can be termed “market surrealism,” meaning that markets do not and cannot reflect what they purport to reflect because of uneven endowment, enfranchisement, and capacity of market participants.<sup>17</sup> Markets can be specious, capricious, and fickle. Sunstein finds that markets are morally arbitrary, coercive, and specious in both ordering and favoritism.<sup>18</sup> A normative failure can be found in transcendent justice, rights, and liberties that, left to their own devices, markets will fail to uphold and often flout. Institutional frameworks are essential, including the frameworks that structure markets and allow them to function. A classical failure is found in public goods, which the market will not produce or chronically under-produce (national defense being the classic example). Similarly, markets do not respond well to global crises that are immediate (such as pandemics) or extended (such as climate change). Markets also do not cope well with extreme risk, volatility, and uncertainty and these may be associated with exogenous market influences (such as international financial systems), but also nonmarket influences (namely, government policies). Finally, a quintessential failure is associated with the somewhat passé concept of “natural” monopoly. Monopolies, such as found in public utility services, reveal significant scale, scope, integration, and network economies and enjoy a sanctioned state of market power because introducing competition could be redundant or even “ruinous.” Markets are also bounded by technical, economic, or financial barriers to market entry or market exit that limit eligible participants. Monopoly and demonstrable market power, of course, provide a particularly salient rationale for economic regulation.

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<sup>16</sup> This framework echoes and builds upon the seminal framework of Carl Kaysen and Donald F. Turner, *Antitrust Policy an Economic and Legal Analysis* (Harvard University Press, 1971).

<sup>17</sup> For a succinct treatment, see Robert H. Frank, “The Invisible Hand, Trumped by Darwin?” *New York Times* (July 11, 2009).

<sup>18</sup> Cass Sunstein, *After the Rights Revolution: Reconceiving the Regulatory State* (Harvard University Press, 1990).

Second-order failures are *transactional* in nature and coterminous with economic exchange. The market might be workable but it is also *inefficient* and competitive outcomes are thus *undesirable*. The Coase Theorem<sup>19</sup> is credited with recognizing that markets fail due to poorly defined property or legal rights, arguing that well-defined rights present opportunities for market-based solutions to disputes, including conflict over externalities. Similarly, engagement in some forms of economic exchange can entail analytical, organizational, transaction, and market-access costs; prohibitive costs disadvantage certain parties. Information failures result from asymmetrical, distorted, biased, or restrained information. The parable of the prisoner's dilemma, for example, illustrates how rational choices yield suboptimal results when information is not fully shared. Because market theory places so much emphasis on the rational behavior of market participants, behaviors that appear inconsistent with this ideal (irrationality, extra-rationality, or other divergences) constitute another form of perceived failure. Modern behaviorists look, for example, to how emotions, norms, and relativity shape behaviors that are irrational yet predictable.<sup>20</sup> Preferences and choices also relate closely to information; for example, irrational propensities may be reinforced by distorted information. Some market participants may misperceive or deny risks or the consequences of their behavior; these may include, for example, perceptions of risks related to financial investments or personal safety. Finally, market transactions inevitably raise the specter of conflicts of interest, moral hazards, perverse incentives, adverse selection and risk shifting behaviors that are largely understood as rational on the part of perpetrators, even as they clearly undermine overall market performance.

Third-order failures are *distributional*. Economic exchange might occur, but its consequences will be regarded as unjust and inconsistent with established core values. With these failures, the market might be workable but it is also *inequitable* and competitive outcomes are thus *unacceptable*. Positive and negative externalities (or spillover effects) in both production and consumption constitute a prime example of this form of failure. These are characterized by the failure of price to appropriately capture and impose the true and full social impact of economic exchange. Pollution is a favorite example of a negative externality; positive externalities in the form of public-health benefits can be found in vaccination and sanitation services. Similarly, some risks, benefits, and costs of exchange (including opportunity costs) can be more formally socialized; that is, they are not confined to parties directly. Markets rather notoriously fail to protect the commons, manage resource scarcity, and ensure resource diversity for today but also inter-generationally; these effects can be not only detrimental, but inalterable. The market may under-supply wanted goods and over-supply unwanted goods. The market will “orphan” drugs that treat unique diseases, under-fund the arts and humanities, and neglect research and development, while products of poor quality or safety are supplied in excess. Dangers are also found in the potential for producers to exploit or abuse inputs, as well as innocents, indigents, or the incapable. The market, for example, might regard child labor or homelessness as rather efficient. Markets are prone to discrimination when discrimination enhances profitability. Of related and special importance are intended or undesirable social or distributional outputs and outcomes. These determinations are based on core social values that place boundaries on behavior but also set goals, such as ensuring against environmental justice and closing the digital divide.

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<sup>19</sup> Ronald Coase, “The Problem of Social Cost,” *Journal of Law and Economics* 3:1 (1960): 1–44.

<sup>20</sup> Dan Ariely, *Predictably Irrational: The Hidden Forces That Shape Our Decisions* (HarperCollins, 2008).

The integral theory of markets, market failure, and economic regulation is derived from a common body of knowledge. In sum (Exhibit 2), markets can fail, or be perceived to fail, in several regards. Markets imperfection can be measured in terms of effectiveness, efficiency, and equity. Each of the particular market failures obviously invites complexity and controversy as to inevitability and interpretation. Each failure relates to other failures, sometimes so closely as to blur the distinctions. Inherent structural failures, for example, will have distributional consequences. None can be dismissed and none can be fixed simply, let alone perfectly. An understanding of market imperfection lends much insight about the immense challenge of collective action and the heavy burden of responsibility that can fall only to the nonmarket state to imperfectly address the imperfect.

Exhibit 2. Typology of market failures

	<b>First-order failures</b>	<b>Second-order failures</b>	<b>Third-order failures</b>
Type of failure	Structural	Transactional	Distributional
Evaluation criteria	Effectiveness	Efficiency	Equity
Competitive outcomes	Unsustainable	Undesirable	Unacceptable
Exemplars	<ul style="list-style-type: none"> <li>• Market surrealism and spe-ciousness, based on uneven endowment, enfranchisement, and capacity</li> <li>• Transcendent justice, rights, and liberties and essential institutional frameworks</li> <li>• Public goods and response to global crises (e.g., national defense, flu response)</li> <li>• Extreme risk, volatility, and uncertainty (exogenous market and nonmarket influence)</li> <li>• “Natural” monopoly (scale and other economies, cost structures, entry and exit barriers, ruinous competition), or market power</li> </ul>	<ul style="list-style-type: none"> <li>• Poorly defined property or legal rights</li> <li>• Prohibitive analytical, organizational, transaction, and market-access costs</li> <li>• Asymmetric, distorted, biased, or restrained information (prisoner’s dilemma)</li> <li>• Irrational, extra-rational, or divergent preferences or choices and misperception or denial about risks (e.g., financial investment or personal safety)</li> <li>• Conflicts of interest, moral hazards, perverse incentives, adverse selection, and risk and cost shifting</li> </ul>	<ul style="list-style-type: none"> <li>• Positive and negative externalities or socialized benefits, risks, and costs (including opportunities)</li> <li>• Failure to protect the commons, manage scarcity, and ensure diversity (i.e., inter-generational and inalterable effects)</li> <li>• Under(over)-supply of wanted (unwanted) goods or services (e.g., orphan drugs, arts, research and development )</li> <li>• Exploitation of inputs or innocents, discrimination, and other abuses</li> <li>• Unintended or undesirable social or distributional outputs and outcomes relative to core social values (e.g., environmental injustice, digital divide)</li> </ul>

Source: Author’s construct.

### 3. Regulatory Failure

Markets, regulation, and deregulation are all institutional creatures, imperfect in their making and their performance. The failures among them are likely institutional as well. Still, the topic of regulatory failure has been dominated by the considerable clout, formidable logic, and artful rhetoric of the neoclassical perspective, which sees economic regulation as mostly a bad theory and thus a poorly formulated policy. Private-interest theories of regulation argue that regulation is imperfect because it is misplaced in the first place and misappropriated in the second place.<sup>21</sup> To a limited degree, they accept market failure but they believe that attempts at alleviation result in regulatory or “nonmarket”<sup>22</sup> failures that can be as deleterious as or worse than the original infraction.

Some of regulation’s most cynical critics have walked the halls of the University of Chicago, iconic thinkers who found a slightly ironic outlet in the *Bell Journal of Economics*. They see regulators as blinded by self interest, deafened by political clamor, and suffocated by influence. The critique centers on the rational rent-seeking motives of politicians and regulators who view market failure opportunistically, as a contrived chance to redistribute wealth via regulation to their personal economic or political advantage.<sup>23</sup> The regulator-politician allocates and reallocates resources not to advance society but to ensure their own survival and prosperity. As if that were not enough, regulators invite their own “capture” by producers (Stigler), coalitions (Peltzman), and over time (Kahn). Their conception of regulation is a distant cry from the public-interest theory of regulation. Lauds the Progress and Freedom Foundation: “[The] ‘public interest’ view of regulation fell short of explaining how things really happened.... Public choice theory is the single most powerful explanation for regulatory behavior. Firms act in their self-interest. Regulators act in their self-interest. There is a market for regulatory favor. Entities will invest in that market commensurate with expected rewards.”<sup>24</sup>

To the Chicago scholars, regulation is doomed. They share a mutually reinforcing view of regulation as *incapable* of achieving its purpose (Hayek),<sup>25</sup> *ineffective* in producing desired results (Stigler), *inefficient* in implementation (Becker), *inclined* toward wealth transfer (Posner),<sup>26</sup> *inflationary* over time due to self-serving behaviors (Wolf), and *inimical* in terms of causing contradictory outcomes (Peltzman).<sup>27</sup> Peltzman also argues that economic progress masks regulatory failure and that deregulation is needed when regulation is found to be a “mistake.”<sup>28</sup> Even well-intended and well-designed regulation (like other public policies) can

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<sup>21</sup> On private-interest and public-interest theories, see Bronwen Morgan and Karen Yeung. *An Introduction to Law and Regulation* (Cambridge University Press, 2007).

<sup>22</sup> Wolf (1988).

<sup>23</sup> George J. Stigler, “The Theory of Economic Regulation,” *2 Bell Journal of Economics* 3 (1971); Richard A. Posner, “Taxation by Regulation,” *2 Bell Journal of Economics* 22 (1971); Kahn (1988).

<sup>24</sup> Progress and Freedom Foundation, “Public Choice: Is there a Public Interest?” *The Skeptical Regulator* (March 2004).

<sup>25</sup> Friedrich A. Hayek, “The Use of Knowledge in Society” *American Economic Review* 35:4 (1945): 519-530.

<sup>26</sup> Richard A. Posner, “Taxation by Regulation,” *Bell Journal of Economics* 22:2 (1971).

<sup>27</sup> Sam Peltzman, “Toward a More General Theory of Regulation,” *Journal of Law and Economics*, 19:2 (1976): 211-240.

<sup>28</sup> Sam Peltzman, “Regulation and the Natural Progress of Opulence. *AEI-Brookings Joint Center for Regulatory Studies* (Washington DC, 2004). See also, Winston (2006).

result in unintended consequences and offsetting effects. Sunstein retorts that markets are adept at overcoming the efforts of regulators to transfer wealth.<sup>29</sup>

The Chicago critique plays directly to the ideological postures of limited government, free markets, and faith-based deregulation. Market theory promulgates a “relentless tautology”<sup>30</sup> and a “romanticized and sanitized” vision of the economy.<sup>31</sup> Markets are the default social option, presumed to work and having the benefit of the doubt. In a forced choice, they prefer imperfect markets to imperfect regulation. The standards by which regulation can be justified are nearly impossible to meet and intervention should be rare at most. The narrow conception of regulation’s role in the market reinforces simplistic perceptions of regulatory failure and potential remedies, including deregulation. Accordingly, regulated markets should be deregulated so that their many theoretical virtues can be realized. If the benefits of deregulation are slow to materialize, simply give it more time. As impatience grows, simply blame the restructuring process itself, including residual structures and cumbersome rules.

Market loyalists are fond of the counterfactual or “what-if” scenario as improvable hypothesis.<sup>32</sup> Economic regulation is vulnerable to counterfactual arguments: what value should be placed on prevention of market power? Deregulation has been rationalized by the counterfactual that unfettered markets would yield substantial benefits (Peltzman). What if we deregulated and left markets to their own devices? Proving a negative is normally futile, but the 2008-2009 financial meltdown presented a unique counter-counterfactual, when reality met hypothesis to near catastrophic result on a global scale. The economy witnessed the “what if” of largely deregulated markets, where greed overtook fear. Rather than driving toward efficiency and innovation, the global financial system was driven to the brink of collapse. The confluence of market failure, regulatory failure, and deregulatory failure proved disastrous for the average financial investor and creditor and fatal to some market participants. Economic recovery will take years, but the public’s trust may be permanently scarred. Continued political upheaval and backlash complicate regulatory and market reforms. Other counterfactuals can be found throughout the U.S. deregulation experience, including electricity markets where restructuring promised much but delivered less than impressive results. The chief good that might stem from these hard lessons is the renewed appreciation of and attention to the role of effectual regulation in the political economy.

Crises and critiques also point to the need for responsive and adaptive regulation. Regulation is conservative by nature because it is protective by necessity. Rules ensure due process, ethical conduct, and continuity. Incremental change avoids the risks associated with non-incremental change. Responsive regulation recognizes that differences in industry structure call for differences in institutional design.<sup>33</sup> Adaptation calls for evolving regulatory institutions as

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<sup>29</sup> Sunstein, “After” (1990).

<sup>30</sup> Robert Kuttner, *Everything for Sale: The Virtues and Limits of Markets* (University of Chicago Press, 1997).

<sup>31</sup> Paul Krugman, “How Did Economists Get it So Wrong?” *New York Times Magazine* (September 2, 2009).

<sup>32</sup> See Sunstein, “To explain a phenomenon by reference to its consequences is bad social science...” Sunstein, “Paradoxes” (1990)

<sup>33</sup> Ian Ayres and John Braithwaite. *Responsive Regulation: Transcending the Deregulation Debate* (Oxford Socio-Legal Studies, 1995).

regulated industries evolve.<sup>34</sup> Institutions that are more adaptive should actually be more stable.<sup>35</sup> What may be appropriate for one sector may be inappropriate for another due to technology-driven structural differences and disruptions. Responsiveness and adaptation aim to overcome antiquated or obsolete methods of regulation, but also to innovate as conditions demand. Failure to adapt has been identified as a major manifestation of regulatory failure: “[R]egulatory failures are products of institution designs where rigidities in the ability of the institutions to adapt to shocks lead to profound disappointment in the public’s expectations. The politically sensitive character of these essential services makes them ripe for instant reform.”<sup>36</sup>

For the most part, the economic regulatory paradigm and its core principles and standards have actually demonstrated remarkable staying power, as well as capacity for responsiveness and adaptation. The traditional regulatory framework has been sustainable because it has accommodated considerable change, including relatively dramatic changes in market structures and jurisdiction. Regulators have absorbed an expanding range of regulatory responsibilities and functions and adopted a variety of new processes and methods. Adaptation still calls for appropriate prudence and pace. Changes to regulations will be sought by parties of interest in venues that work to their advantage. Adaptive change also carries the risk of instability, as well as the loss of crucial authorities. Some might argue that in the rush to deregulate, regulatory institutions were altered permanently and prematurely relative to market maturity. The problem for regulation may be less in the institutional capacity to respond or adapt than in the willingness to respond or adapt as pressing conditions warrant and obtainable authorities allow. As Sunstein found, “Importantly, nearly all of the [regulatory] paradoxes are a product of the government’s failure to understand how the relevant actors—administrators and regulated entities—will adapt to regulation.”<sup>37</sup>

Responsiveness and adaptation also highlight the dilemma found in the perennial tradeoff between rules and discretion. Regulators need room to apply their judgment in the determination of the public interest, but stability and continuity are also legitimate concerns. Logically, and in practice, the specificity of rules and the degree of discretion are inversely related. Some regulatory reformists focus on the need for regulatory restraint. In the context of developing economies and liberalized markets for infrastructure services, the World Bank has advocated less discretion in the interest of regime stability.<sup>38</sup> In the wake of the financial crisis and obvious institutional failures, Becker<sup>39</sup> and others have called for more rules and less discretion. Less

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<sup>34</sup> Barbara A. Cherry, “The Telecommunications Economy and Regulation as Coevolving Complex Adaptive Systems: Implications for Federalism,” *Federal Communications Law Journal* (March, 2007).

<sup>35</sup> McDermott and Peterson (2006). The authors suggest further that adaptation allows for “institutional equilibrium.”

<sup>36</sup> McDermott and Peterson (2006), 89.

<sup>37</sup> Sunstein, “Paradoxes” (1990).

<sup>38</sup> “... [A] credible regulatory system requires more than a formally independent regulatory entity... other transitional arrangements may need to be established... including limiting the amount of discretion that regulatory bodies have in setting prices and key parameters,” in “Public and Private Sector Roles in the Supply of Electricity Services,” Operational Guidance for World Bank Group Staff, 2004, as cited in Ashley Brown, et al., “A Handbook For Evaluating Infrastructure Regulatory Systems, presented at the INFOSHOP, World Bank (October 2, 2006).

<sup>39</sup> “One major problem with regulations is the regulators themselves. They get caught up in the same bubble mentality as private investors and consumers. For this and other reasons, they fail to use the regulatory authority available to them. This implies that as much as possible, new regulations should more or less operate automatically

contemplated, but perhaps more needed, is an appropriate social investment in regulatory capacity as a means of enhancing both rules and discretion and bolstering the legitimacy of the agencies that wield them.

Recent events have made the case for advancing regulatory theory and improving regulatory capacity. Modern regulation suffers in many respects from marginalization and a dearth of intellectual argument. Institutional economics have been overshadowed and intimidated by welfare economics and public choice. To accept the prevailing economic theory is to deny the public interest, accept market failure, and concede that regulation is so inherently flawed that it cannot be improved. Regulation's proponents must move beyond nostalgia, regret, and apology if they are to launch a credible counter theory to guide normative and empirical explorations of how both public and private interests motivate and mold regulation. Modern regulation also exists in a weakened state due to precarious political support. Society asks much of regulation but gives it very little. Regulation needs intellectual champions in academia and political champions in office if it is to have a fighting chance.

In many important respects, economic regulation is actually a sound theory because it effectively recognizes and addresses market failures that are very real and very relevant. As an imperfect substitute for competition that balances the interests of producers and consumers, the traditional model of public utility regulation has both strengths and weaknesses (Exhibit 3). On the whole, and over a distinguished history, the advantages or benefits outweigh the disadvantages or costs. Many of regulation's strengths relate to its institutional legitimacy and structure. Many of regulation's shortcomings can be and are being addressed through responsive and adaptive methods, without compromising the underlying social compact. Regulation fails less in theory than in practice because we fail regulation.

#### **4. Failing Regulation**

The imperfection paradox holds that perfect regulation will never and should never exist. Some of the failures of regulation may be theoretical and some may be structural, but many of regulation's apparent structural failures are actually by design because they are necessary for regulation to accomplish its broader purposes. The rhetoric of regulatory failure also misses the point that more often than not, regulation is failed. Failures of regulation, though prevalent, are not necessarily inherent. Some are failures of political will. Some are the result of deliberate and complicit efforts to weaken regulation. Many are manifestations of modern politics that permeate governance and public policymaking. Most can be remedied if the body politic is willing.

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rather than requiring discretionary decisions by regulators.” Gary Becker, “Financial Regulation” (March 9, 2009). *The Becker-Posner Blog*, [www.becker-posner-blog.com](http://www.becker-posner-blog.com).

### Exhibit 3. Strengths and Weaknesses of Public Utility Regulation

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Strengths	<ol style="list-style-type: none"><li>1. Mature and generally well proven (100-plus years of implementation experience).</li><li>2. Intellectually reasonable in terms of economic theory (markets and market failure).</li><li>3. Institutionally legitimate, grounded in constitutional principles and rule of law.</li><li>4. Balances competing interests of shareholders, ratepayers, and society.</li><li>5. Ensures due process and consideration of justice in ratemaking.</li><li>6. Provides transparency and accountability.</li><li>7. Applies consistent methods producing relatively consistent results.</li><li>8. Provides for market structure and stability.</li><li>9. Encourages long-term infrastructure investment of scale.</li><li>10. Provides reasonable, if imperfect, performance incentives associated with various goals.<sup>40</sup></li></ol>
Weaknesses	<ol style="list-style-type: none"><li>5. Too much incentive for cost-maximization and over-investment (“gold-plating”).</li><li>6. Too little incentive for cost control and managerial innovation (“clawing back the savings”).</li><li>7. Prone to regulatory lag and delay of cost recovery.</li><li>8. Driven by arcane and adversarial process more than by results.</li><li>9. Historical focus and reactive (e.g., historic test years, no pre-approvals).</li><li>10. Sometimes intrusive, retroactive, or punitive (e.g., micro-management or prudence reviews)</li><li>11. Emphasis on negative v. positive performance incentives.</li><li>12. Somewhat inflexible with regard pricing experimentation.</li><li>13. Focuses too little on social or environmental issues (externalities).</li><li>14. Allegedly prone to “command-and control” or “central planning.”<sup>41</sup></li></ol>

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Source: Author’s construct.

Based largely on observational method, a dozen ways that regulation can be failed are briefly reviewed in the following conceptual framework (Exhibit 4). For the most part, though they are drawn from public utility regulation; most apply to economic regulation generally and other forms of regulation as well. The typology is meant to be illustrative, but not exhaustive or exclusive. Many of the failures cited are highly nuanced and closely interrelated, such that addressing them might alleviate others. Some are close to contradictory. For example, while independent regulation places much emphasis on broad discretion, abuses of discretion create another set of problems. While none of these challenges are easily solved, none are insolvable. Meaningful reform will depend on the commitment of regulators and the political offices on which the institution of regulation depends.

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<sup>40</sup> Ratebase/rate-of-return regulation is a form of incentive regulation.

<sup>41</sup> For a discussion, see McDermott and Peterson (2006).

## 4.1 Failures of Culture

1. Regulators may under-appreciate the public interest, the social compact, or their vital role in upholding regulatory principles. Even for the well-initiated, the concept of the public interest can be difficult to grasp, let alone to operationalize. The public utility regulator is at once a trustee, expert, and judge operating in a quasi-legislative, quasi-administrative, and quasi-judicial capacity.<sup>42</sup> The job is daunting and humility has more value than hubris. Regulation falters when those elevated to serve fail to assimilate or misconceive their complex mission to safeguard the public interest; following their appointment or election, role models, mentorship, education, and socialization may be inadequate. Likewise, the binding yet unwritten compact between society and monopolies that undergirds regulation may not be fully understood; in some cases, it might be implicitly or explicitly rejected in favor of an alternative paradigm or political agenda. Over time, even dedicated regulators can become complacent and lose sight of their mission. The rate of turnover among regulators suggests that long-term commitment to the position may be lacking; indeed, regulators may be at best distracted by, at worst driven by, future plans. The appointment or election of qualified regulators who bring integrity and intellectual curiosity to the position is essential, along with inculcating a commitment to the public interest.

### Exhibit 4. How We Fail Regulation

Failures of culture	<ol style="list-style-type: none"><li>1. Regulators may under-appreciate the public interest, the social compact, or their vital role.</li><li>2. Regulation can be uninformed, uncritical, or worse unintelligent in approach.</li><li>3. Regulators may be unable or unwilling to make tough decisions, take corrective action, or adapt.</li></ol>
Failures of capacity	<ol style="list-style-type: none"><li>4. Regulatory agencies may have inadequate jurisdiction and enabling authority.</li><li>5. Regulatory agencies may have insufficient resources or technical capacity.</li><li>6. Regulators may not effectively deploy their authorities, resources, or capacity.</li></ol>
Failure of climate	<ol style="list-style-type: none"><li>7. Regulation can impose transaction costs and process and decision inefficiencies.</li><li>8. Regulation may be uncoordinated or disharmonious, resulting in conflicting performance signals.</li><li>9. Regulatory climate may be perceived as poor in terms of misuse of discretion, uncertainty, and risk.</li></ol>
Failures of coercion	<ol style="list-style-type: none"><li>10. Regulation can become prone to ideological arguments and partisan politics.</li><li>11. Regulation can be susceptible to influence and ethical challenges, including bias and capture.</li><li>12. Regulation can lack political support, succumb to interference, and lose independence.</li></ol>

Source: Author's construct.

<sup>42</sup> Janice A. Beecher, "The Prudent Regulator: Politics, Independence, Ethics, and the Public Interest," *Energy Law Journal* (2008): 577-614.

2. Regulation can be uninformed, uncritical, or worse unintelligent in approach or method. Regulation is hardly ignorant, but it may not always be well-informed. Regulators need to acknowledge what they know and do not know and realize that they do not need to be all-knowing to provide effective performance incentives. Public utility regulation can be challenging to grasp, given the depth and breadth of its intellectual and interdisciplinary underpinnings in economics, law, accounting, finance, engineering, and public policy. The embedded information asymmetry that favors the regulated over the regulator and all other parties intensifies the challenge. Abuse of the information advantage is a form of “moral hazard.” Regulators must be ever discerning and vigilant about bias, seeking out objective insight whenever possible. Information is empowering; compelling the production of information is a powerful tool of the astute regulator, as is the reliance on an expert professional staff for its digestion. Limits to information make critical analysis all the more important. Overwhelming problems can lead to over-simplified solutions. Such may be the risk in the many panaceas of modern regulatory and deregulatory policy. Intelligent regulation calls for a more principled, reasoned, skeptical, and rigorous approach, not to the exclusion of social values but toward ends informed by social values. The methods of regulation must also be designed and implemented on the basis of both sound theory and empirical validity.

3. Regulators may be unable or unwilling to make tough decisions, take corrective action, or adapt to changing circumstances. Regulators must not only understand their role, but have the confidence and conviction to make difficult, unpopular, and even politically incorrect decisions. Regulation usually leaves most parties wanting because the stakes are high and compromises must be struck. At times the public interest may call for outright rejection of hard-fought positions or complex settlement agreements. Regulators must assert their independent judgment even in the face of considerable political pressure from executives and legislatures, and even from other regulatory bodies. The restructuring of U.S. electricity markets has been a lesson in cognitive dissonance over a theory that favored markets and contradictory empirical findings. Similar tensions may arise for climate response and energy resource policies with respect to technical and economic constraints. In the face of compelling evidence, acquired by legitimate research methods and procedures, the honest regulator must be willing to chart a corrective course that might run contrary to their own preferences or political self-interest. A more technocratic approach is beneficial in this regard, although political will remains essential. Regulation should follow the paradigm of “policy as experimentation,” using test cases and pilot programs as appropriate. Policy changes and process improvements should incorporate rigorous monitoring and evaluation systems to inform subsequent policy design and implementation. Regulators need to be responsive without sacrificing core principles and accountabilities, but some adaptation is essential to ensure continued relevance and efficacy.

#### 4.2 Failures of Capacity

4. Regulatory agencies may have inadequate jurisdiction and enabling authority. Although conceived as independent, regulatory agencies are also creatures of legislatures and extensions of executives. They rely on the legislature to ensure that their jurisdiction and authority is adequate, and that they have room to exercise discretion. Philosophies differ about whether regulators should make policy or whether they should merely implement policy, but in practice the two are largely inseparable. Overly prescriptive and specific legislation or rules not only ties the hands of current and future regulators, but can lead to obsolescence and thwart adaptation. A

challenge for modern regulation is keeping pace with technological and structural dynamics to see that decision processes are efficient and that standards and incentives are effective. Expanded jurisdiction may be needed to fill the vacuums left by structural change, especially with respect to potential abuses of market power. Expanded authority may be needed in some areas, such as planning, certification, facility siting, and corporate governance. Regulators should be engaged in the legislative process, not as lobbyists but as authoritative and informative subject-matter experts. Consensus will help ensure that authorities are commensurate with responsibilities and reforms are in the public interest. Consistent with the ideals of independence, regulators should enjoy both broad authority and discretion within a “zone of reasonableness”<sup>43</sup> and subject to appropriate mechanisms of accountability.

5. Regulatory agencies may have insufficient resources or technical capacity. Regulatory authority and discretion without resources and capacity are obviously problematic. Regulators normally exact fees in support of their mission from regulated entities, although some agency budgets are routed through general funds. Regardless of revenue source, expenditures must be duly authorized and budgets can be vulnerable when resources run low or when politics run high. Many regulatory agencies have found themselves under-resourced relative to growing responsibilities and workloads. Many new regulatory mandates, such as market monitoring, call for specialized knowledge and skills. Labor-force reductions, both voluntary and otherwise, have contributed to not just under-staffing but a loss of both technical expertise and institutional knowledge. Inter-disciplinary regulatory capacity makes for more informed, effective, and efficient regulation. Regulatory capacity also provides a critical counterbalance to information asymmetry, particularly with regard to technical issues. Regulators also need to invest in education and research that is focused on their mandate to serve the public interest. Applied academic research following rigorous standards for design and review is especially needed, which regulators must support both financially and politically even when conclusions test sensitivities.

6. Regulators may not effectively direct and deploy their authorities, resources, or capacity. Most enabling statutes grant relatively broad authority to regulate in the public interest. The standards that guide regulation—prudence, justice, reasonableness—are potent. Regulators need to wield their authority well as conditions demand.<sup>44</sup> The courts, moreover, also allow regulators considerable leeway in exercising primary jurisdiction, so long as due process is accorded. But regulators must choose to deploy their endowments strategically and effectively, at times even testing the boundaries of their authority or challenging potential pre-emption. Some authorities, such as cost-adjustment mechanisms, must be used with due care to ensure that regulation is not automated and that standards of review are not circumvented. Independent regulators benefit from an independent and professional staff that can provide analysis, options, and recommendations. Planning, organizational development, and executive management can improve agency operations. Regulators must devote resources to investigatory fact-finding, to market and corporate monitoring, and to reporting requirements. Submissions by regulated entities must be reviewed in appropriate detail. Regulators must be willing to set meaningful

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<sup>43</sup> Per the Constitution and the law, the courts cannot set aside any rate selected by the Commission which is within a “zone of reasonableness” (that is, the courts should not second guess regulators). *Permian Basin Area Rate Cases* 390 U.S. 747, 790 (1968).

<sup>44</sup> See Becker (2009) and footnote 38 here.

standards and enforce them by appropriate means, including citations, audits, and penalties. Ultimately regulation is about inducing desirable behaviors and deterring undesirable behaviors and regulators must be willing to provide both positive and punitive performance incentives.

#### 4.3 Failures of Climate

7. Regulation can impose transaction costs, including process and decision inefficiencies. All forms of regulation consume time and other resources. Some transaction costs are inevitable, and should be more than offset by social benefits. Regulated utilities assume these costs as part of the social compact but they are a source of constant consternation. The often protracted time lag between filing a case and its ultimate disposition is a near universal criticism because it goes directly to corporate cash flow and profitability. The regulatory process is largely reactive, placing a burden of proof on utilities to make their case for rate changes or other forms of relief. The quasi-judicial nature of the process, including the emphasis on ensuring due process, adds to time and costs. Abuses in the discovery phase (such as excessive data requests) can be inflicted by any of the parties; regulators bear a special responsibility to use this authority well. Process efficiency suffers when staff resources are overstretched but resource limitations also argue for procedural innovation. Some of the remedies for regulatory lag include a forward-looking test year for establishing rates, time limits on rate cases, and interim rates subject to refund. Many regulators today employ alternative dispute resolution, including stipulation and negotiated settlement subject to regulatory review and approval. Procedural alternatives can be targeted to the needs of smaller companies or particular policy problems. Electronic filings, web-based resources, and modern communications technologies can also be used to streamline and lower the cost of regulation.

8. Regulation may be uncoordinated or disharmonious, resulting in conflicting performance signals. In the US, continuity and legitimacy in regulation are supported by the application of relatively consistent methods and judicially established standards. Nonetheless, among the leading practical criticisms raised by regulated firms is that regulation does not provide adequate clarity or consistency for them to make strategic capital and operational decisions, and to win favor with investors. Regulatory federalism and the shared jurisdiction of federal and state agencies contribute, as do complex market structures that include multi-state utilities and unregulated market segments. Structured electricity markets are encumbered by layers of market rules and instruments each meant to correct for the shortcomings of previously adopted rules and instruments. Inconsistent or conflicting policies and priorities can be found within and across jurisdictions and from one political administration to another. Uncoordinated approval processes can be arduous, time-consuming, and expensive. Monitoring and enforcement can seem arbitrary. The result can be suboptimal performance by utilities that in turn undermines social goals. Regulation would benefit from a more concerted effort in standards development and coordination, as well as in process improvements for their implementation.

9. Regulatory environments may be perceived as poor in terms of misuse of discretion, uncertainty, and risk. The general regulatory environment can be a tricky topic for regulators because perceptions depend entirely on perspective. A climate “too hot” discourages investors, but a climate “too cold” discourages the public. Either case may lead policymakers to turn to various regulatory or structural reforms. For regulated utilities, certainty is a defining determinant of regulatory climate. In many respects, political stability may be more important

than political leanings, policy continuity may be more important than policy content, and decision predictability may be more important than decision direction. Regulatory discretion is accepted so long as it is not arbitrary or capricious. Perceptions of uncertainty correspond to perceptions of risk, and regulatory risk along with business risk relates to the cost of capital. Some of the major investment houses that rate utility credit quality also rate the utility regulators. Focusing primarily on investment returns; higher ratings go to agencies perceived as more investor-friendly. A lesser rating may be more appealing from the consumer advocate's perspective, but a very low rating will raise the cost of capital that consumers ultimately bear. Increasing regulatory independence should reduce the effects of political turmoil. Improving regulatory capacity might toughen the environment, but an adaptive environment with both smart rules and wise discretion will promote stability over the long run.

#### 4.4 Failures of Coercion

10. Regulation can become prone to ideological arguments and partisan politics. Disagreements about the role of regulation are often associated with ideologies about the role of government itself, which in turn will color values and perceptions. The model of independent regulation rests heavily on the concept of political separation and independence. Party affiliation should not be a reliable predictor of regulator behavior. Political loyalty can creep into the appointment processes, in some cases eclipsing relevant credentials. Many of today's regulators find the job after serving in political roles, sometimes elected office and sometimes in service to an elected executive. Some may have partisan perspectives coming into the role and view regulation as merely an alternative policymaking venue. Some will seek organizational transformation to ensure that agency staff will be supportive of their agendas. A nontrivial number of politicians and regulators in recent years have seemed more interested in deregulating unproven markets than regulating proven market failures. The ideological, even "faith-based," undertones of the movement to restructure and deregulate utility markets are undeniable. Ideology can trump theory and theory can trump facts, even among academic pundits. For regulation to move forward as an institution, the role of ideology from either the right or left should be far more limited.

11. Regulation can be susceptible to influence and ethical challenges resulting in bias and even capture. Regulation provides for the legitimate pursuit of legitimate interests, but not all interests are equally endowed. Influence can be attempted by third-party agents and take many forms. Bias stemming from special access, aggressive lobbying, and untoward influence is a very vexing form of regulatory failure because it violates the core values of independent regulation, as well as the public trust. These failures exaggerate perceptions of broader institutional failure and feed reform impulses that may or may not be socially beneficial. As impartial arbiters, regulators should avoid impropriety and the appearance thereof. Rules for openness help ensure transparency. Rules of conduct address conflicts of interest, communications with interested parties, and corruption in the form of the egregious *quid pro quo*. Breaches play directly into the private-interest theory that views regulators as more oriented to their self-interest than to the public interest. In the regulatory life cycle, even dedicated public servants may devolve over time, identifying more closely with the industries they regulate and either surrendering to or inviting capture. A revolving door beckons regulators with lucrative employment once transitory stay-out requirements are met. Though difficult to instill, regulators must pledge their fidelity to public service and commit to the highest standards of ethics; they should also face steep penalties

for noncompliance. Regulatory associations and educational programs should play a supportive role as well.

12. Regulation can lack political support, succumb to interference, and lose independence. Surely the most serious institutional threat to regulation is the potential loss of political independence. The independence of regulators is bounded by necessary mechanisms of accountability,<sup>45</sup> but some of the boundaries have come under assault. Regulators can be a misunderstood and maligned lot, often unappreciated until a crisis arises and then often chastised for inadequacy in either foreseeing or responding. Today's executives and legislatures may place less value on independence, viewing regulators as extensions of their offices and instruments for their policy agendas. Term-limited legislators without institutional memory may be quick to judge regulation. Not only do politicians often fail to support the concept of independent regulation and those who serve it; some actively attempt to interfere or hold sway by threat of removal or even agency abolishment. Self-preservation and political ambition may influence how regulators regulate. For some agencies, independence of the professional regulatory staff has also waned in the face of a more politicized regulatory environment. The loss of political independence is as perilous to regulation as the loss of independence from regulated industries; both undermine the core structure of a vital policy institution. Re-establishing regulatory independence should be a reform imperative.

## 5. Conclusions

Markets and regulation are imperfect but essential and entwined institutions. Perfection for either is neither possible nor desirable. Both markets and regulation are vulnerable to charges of failure and failure can have lasting institutional consequences, including the pursuit of institutional alternatives. While market failures justify regulation, regulatory failure cannot justify deregulation in the presence of persistent and intolerable market failures. In fact, politics and policy must support re-regulation when restructuring fails to meet standards and expectations. Moving beyond the rhetoric of markets versus regulation focuses attention on understanding the symbiosis of markets and regulation through integrative theory and methods. Institutional development is critical to regulatory sustainability, as well as efficacy.<sup>46</sup> Fundamental to reform is confronting and overcoming the ways that we fail regulation as an institution.

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<sup>45</sup> Beecher (2008).

<sup>46</sup> The U.S. is not alone in this endeavor. Institutional development is an emerging global priority. The 2009 World Economic Forum on competitiveness elevated institutional effectiveness as the first of twelve pillars: "The institutional environment is determined by the legal and administrative framework within which individuals, firms, and governments interact to generate income and wealth in the economy. The importance of a solid institutional environment has become even more apparent during the current crisis, given the increasingly direct role played by the state in the economy of many countries." Professor Klaus Schwab, ed., *The Global Competitiveness Report 2009–2010, of the World Economic Forum*, Geneva, Switzerland (2009). Available at [www.weforum.org](http://www.weforum.org).