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REGULATORY INSTITUTIONS AND STRUCTURES

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REGULATORY INSTITUTIONS AND STRUCTURES

INTRODUCTION

It is obvious that regulatory structures and institutions play a key role in the environment necessary to promote enterprise. In its document *DFID Enterprise Development Strategy* (EDD, 2000), the Enterprise Development Department refers to the need for "competent legal and regulatory institutions … and sensible regulation on health and safety, business registration and trade licensing" (para 3.6.2.), contrasting that with "a heritage of heavy state intervention, unfavourable government policy, outdated law and excessive regulation [which] still persists, factors that heavily constrain enterprise" (para 3.6.4).

What are the main characteristics of a "good" or "sensible" regulatory system? The answer to the question has two dimensions. The first relates to **the instruments or legal forms** selected to achieve the desired objectives. These should be appropriate in the light of the economic and social justifications for intervention and of their predicted impact on the regulated community. The second relates to **the procedures or processes** by which the instruments are formulated and applied. Clearly a regulatory regime cannot succeed unless its operation has legitimacy within the community it serves. To this end, certain process values must be recognised, including those of expertise, transparency, and accountability.

In this paper, drawing on the familiar legal, and legal-policy literature,[1] I seek to summarise the main ideas relating to the two dimensions described above and thereby to derive research issues applicable to developing economies. My methodology is derived from what may be described as the sub-discipline of law-and-economics. In relation to regulation, the movement has generated two forms of analysis.

Public interest analysis makes a major input to the instrument dimension. It involves a three-stage inquiry: identifying and explaining instances of market failure; investigating alternative methods of correcting the failure; and predicting the response of actors to the different methods,

[1] Notably: Breyer, 1982; Sunstein, 1990; Ayres and Braithwaite, 1992; Ogus, 1994; Baldwin, 1995a; Prosser, 1997, Gunningham and Grabosky, 1998; Baldwin and Cave, 1999

with a focus on the minimisation of administrative costs, particularly information and enforcement costs.

In sharp contrast, **private interest analysis,** developed from the Virginia School of "public choice", seeks to explain how regulatory principles and structures may diverge from what is desirable in terms of the public interest, because politicians and bureaucrats may be motivated to meet the demands of private interest groups who seek the advantages which regulation cast in a particular form may confer on them. This clearly has major implications for the procedural dimension of "good" regulation, because it becomes necessary to explore what constitutional and procedural arrangements can best constrain behaviour of this kind.

REGULATORY INSTRUMENTS AND FORMS

The choice of an appropriate regulatory instrument must, in the first instance, depend on the justification for the intervention. Once the justification, or justifications, has/have been identified, the policy-maker is then faced with a choice between different instruments, each with its own set of advantages and disadvantages. Although other modes of reasoning are not to be excluded, the question then typically becomes one of selecting the instrument which can meet the regulatory objective at lowest cost.

(1) Justifications for Intervention

Logically regulation should only exist where the unregulated market will fail to reach the desired outcomes. But historically, government have perhaps been too ready to embark on regulation without first ascertaining whether the intervention is really necessary. In consequence it is often difficult to identify the exact reasoning which motivated the intervention. Nevertheless, on the basis of the standard literature, we can attempt a non-exhaustive list of the justifications most often cited. These may be conveniently divided into *economic* and *non-economic.*

The main economic instances of market-failure are:

- **Monopolies** or a significant impediments to a competitive market

- **Inadequate or asymmetrical information** affecting the relationship between suppliers and consumers

- **Externalities** (spillover effects) whereby activities affect third parties in ways not reflected in the prices set by producers

- **Co-ordination problems**: though desired outcomes can in principle be achieved by private transactions, the costs of co-ordination are so high that it is cheaper for the law to prescribe conduct.

Among the most important non-economic justifications are:

- **Distributional justice**: the unregulated market leads to outcomes which do not accord with what is a perceived just distribution of resources

- **Paternalism**: individuals are (in relation to the particular area of intervention) assumed not to be the good judges of, or are not trusted to act in accordance with, what is in their own best interest.

(2) Inadequacies of Private Law Remedies

It is not always appreciated that in relation to most of the phenomena described above as justifying regulation private law remedies exist, capable in principle of solving the problem. So, for example, private property rights are used to internalise externalities and contracts are sometimes not enforceable where they are used in situations of information asymmetry. Arguably, such private solution should take priority because they allow those adversely affected to have their grievances addressed directly, without the heavy hand of state intervention. If that is right, those arguing for (public law) regulation should be able to demonstrate a failure of private law to solve the given problem.

In many situations, it will not be difficult to show private law failure. The chief problem afflicting private law is that of transaction costs. Rationally, individuals and firms will only seek to enforce rights where the expected benefits exceed the expected costs, which include not only legal expenses but also time and trouble. Given the general principle that compensation for the

infringement of private rights should not exceed the losses sustained by the plaintiff, many legitimate claims are for this reason not pursued. Thus externalities which affect large numbers but which impose only a small loss on each individual right-holder will not be internalised by private law instruments and serious misallocations will remain uncorrected. The inhibitory impact of the costs of private enforcement is exacerbated in cases where it is difficult to acquire the information necessary to pursue a successful claim, particularly where high technology is involved and where complex causation questions arise.

(3) Regulatory Instruments: Social Regulation

There is a wide variety of regulatory instruments and no consensus on how they should be classified (Mitnick, 1980). Nevertheless, it may be helpful to consider separately the main forms used in two different areas of regulation: *social regulation* which deals with such matters as health and safety, environmental protection and consumer protection and tends to be justified by reference to externalities and asymmetric information; and *economic* regulation which is invoked where there is insufficient competition. In this section I consider social regulation.[2]

A commercial or industrial activity pollutes the environment or generates hazards for health and safety; a professional activity – say that involving the giving of legal or investment advice – involves the risk of financial losses. How can these activities be controlled?

Note, first, that the regulatory aim should not be to eliminate loss; rather it should be that of achieving an optimal degree of loss abatement, the point where the marginal benefits of reducing the loss are equivalent to the marginal costs, the latter reflecting the administrative and other costs associated with the regulatory regimes, as well as the compliance costs of the regulated firms. Among the possible methods of securing optimal loss abatement, the following are the most important.

[2] The arguments assume that the instruments are applied individually. For consideration of combination of instruments, see Gunningham and Grabovsky, 1998, 422-453.

(a) Prior Approval

This regulatory form requires that firms, before lawfully engaging in an activity or supplying a product or service, must first obtain a licence or permit from an authorising agency; and for such approval they have to satisfy the agency that certain conditions of quality are, or are capable of being, meeting the requirement of optimal loss abatement

The administrative costs of scrutinising all applications is very high and to these must be added the opportunity costs arising from any delay before the licence is granted. Moreover, significant welfare losses arise if the system is used for the anti-competitive purpose of creating barriers to entry (Moore, 1961). The benefit from prior scrutiny must therefore be very large to justify, on public interest grounds, these substantial costs.

Two sets of circumstances in which such large benefits are likely to arise may be identified (Shavell, 1993). The first comprises cases (e.g. nuclear accidents) where the consequences of performance failure may be so catastrophic, or the social aversion to them so high, that prior scrutiny and prevention is perceived to be preferable to deterrence from the threat of ex-post sanctions. In sharp contrast, the second category does not necessarily give rise to large losses in individual cases. The problem, which is particularly acute in relation to the provision of services, is rather that of expressing or measuring a variety of characteristics of performance in a sufficiently succinct and yet comprehensive manner that they can be formulated as enforceable standards. The assessment of a multitude of factors is facilitated by the case-by-case approach adopted in the licensing process.

(b) Mandatory Standards

The standards technique allows the activity to take place without any ex ante control but the supplier who fails to meet certain standards of quality commits an offence. Standards can be subdivided into: **performance** (or **output**) standards requiring certain conditions of quality to be met at the point of supply, but leaves the supplier free to choose how to meet those conditions and **specification** (or **input**) standards compelling the supplier to employ certain production methods or materials; or prohibiting the use of certain production methods of materials.

The most important economic variables in choosing between these types of standards are the costs of being informed on the technological means of achieving the regulatory goals and the administrative costs of formulating appropriate standards and monitoring compliance (Stewart,

1981). In principle, firms should be given choice as to how to meet the goals, since that encourages innovation in loss abatement techniques. Hence, there is a presumption in favour of less interventionist measures. However, the benefits of such measures might be outweighed by the costs of administering them and/or the costs to firms of acquiring information on loss abatement technology.

The principal advantages of **specification** standards relate to administrative costs. It is easier for the standard-setter to predict compliance costs, since these vary little from one firm to another. As regards monitoring, the enforcement agency has simply to verify that the prescribed input has been used by firms, or, in the case of a negative standard, that a prohibited substance or process has not been used. The firms, themselves, do not face uncertainty as regards either the law or the action necessary to achieve particular outcomes.

There are, on the other hand, significant disadvantages to specification standards. The fact that the standard is imposed at an earlier stage in the production process implies that the standard-setter has a (perhaps inappropriately) high level of confidence that the mandatory inputs will accomplish the regulatory goal in a cost-effective manner. The prohibition of other inputs induces technological rigidity, since it inhibits firms from innovating in general and from developing other, and cheaper, means of meeting regulatory targets in particular. Specification standards become obsolete very rapidly and there is typically a delay before technological changes are reflected in the regulations. These consequences may give rise to major social welfare losses.

It follows that the case for specification standards is weak unless the standard-setter has better access than firms to information concerning the technology of production and unwanted effects, or firms (or their products) are sufficiently homogeneous that innovative activity is unlikely to occur or to generate significant social benefits.

Standards (whether performance or specification) may be either uniform or differentiated according to region, industry or firm. Uniform standards are very much cheaper to formulate and enforce and they are less susceptible to being manipulated to protect private interests. But if the public interest goal is to minimise the sum of the costs arising from a given activity and of the costs of modifying that activity to reduce the harm, both sets of cost may vary according to the circumstances of the firm, its location, or the population affected by the activity. Formulating

standards on the basis of "average" costs will then inevitably lead to some mismatches and welfare losses. Standards should then be differentiated where the benefits of reducing these losses exceed the additional administrative costs of formulation and enforcement (Latin, 1985).

(c) Information Disclosure

Rather than impose standards on suppliers, forcing them to adopt optimal loss abatement, legislation may simply require that they disclose to purchasers and others information regarding harms or risks which may arise from the activity or product.

Individuals do not have homogeneous preferences regarding quality and safety: some prefer a package of higher quality/safety at a higher price; others lower quality/safety at a lower price. If regulation forces suppliers to reveal adequate information as to quality/safety, on the basis of which consumers can exercise choice, market transactions will ensure that preferences are met; and there will be no welfare losses from consumers being deprived of choice, as can occur under a standards regime (Schwartz and Wilde, 1979). Moreover, mandatory disclosure will reduce costs where the consumer is the least cost-abater, notably by responding to published warnings. The administrative costs of formulating and enforcing disclosure rules are also relatively low, given in particular that policy-makers do not themselves have to determine optimal levels of loss abatement.

On the other hand the potential application of this technique is limited since not all those affected by the product or activity will receive the information and be able thereby to adapt their behaviour or enter into appropriate transactions. Moreover, even within the narrower group of purchasers who can use the information there may be problems. It may be impossible to summarise the necessary information in a form which the great majority will read and understand. The "bounded rationality" of individuals may constitute a further obstacle: there is evidence that individuals tend to overestimate risks associated with low-probability events and underestimate those arising from higher-probability events. Given the often significant costs to purchasers of assimilating information and making decisions, it may be cheaper to force suppliers to adjust the product or service to what purchasers would presumptively have chosen if those intellectual processes had been completed. This solution may be particularly apposite where the costs arising from consumer error are high, for example where death or serious personal injury may result.

(d) Economic Instruments

As an alternative to compelling optimal loss abatement by the threat of a sanction (often called "command-and-control" regulation) governments can attempt to achieve the same ends by economic incentives. The most important form of such incentive is a tax or charge: conduct is legally unconstrained but if a firm chooses to act in an undesired way it must make the stipulated payment.[3]

To correct misallocations arising from externalities, the amount set should be equal to the marginal damage which the individual or firm inflicts on others. Because the external cost of the activity is thereby borne by the actor, this should, if the activity takes place within a competitive market, ensure an allocatively efficient level of production and consumption (Baumol, 1972).

An important advantage claimed for taxes is that, provided the agency can make a reasonable estimate of the damage costs, it need have no knowledge of the abatement costs. Once a tax has been set to reflect the damage costs, it is left to individual firms to decide whether it is cheaper to pay the tax or else to abate. Further, the system provides better information for firms on the costs they will incur from the legal intervention: the tax represents a certain sum, whereas what they will have to pay if they contravene a standard depends on such uncertain variables as the enforcement discretion of the agency and the sentencing discretion of the court. Finally, since, under a tax system, the cost to a firm increases in line with the amount of damage, there is an incentive for the firm to reduce the latter as much as possible. In this respect, it would appear that taxes are superior to command-and-control regulation: although a firm will seek to find the cheapest way of meeting a standard, once that standard has been achieved it has no incentive further to reduce the damage.

These are powerful arguments but some qualification needs to be made (Ogus, 1998). Without information on abatement costs, an agency will be unable to predict how much damage will actually result from a given set of prices and thus how effective those prices will be in relation to the efficiency goal. To overcome this difficulty, the agency will in practice have to adopt an iterative or "trial and error" approach: an initial set of prices is established but these are subsequently modified as their impact is observed and as account is also taken of other variables.

[3] Subsidies and tradeable emission rights are other economic instruments sometimes used.

(4) Regulatory Instruments: Economic Regulation

As indicated above, economic regulation applies to markets which are insufficiently competitive. Two different, but sometimes complementary, approaches must be considered here. Although not generally considered to be "regulation", competition law is the primary instrument for proscribing anti-competitive practices and thereby preserving or enhancing the competitiveness of markets. Where, however, it is deemed appropriate – generally because the conditions for a "natural monopoly" apply – for there to be a single supplier, legal measures must be introduced to control the price and quality of products and services. The discussion is divided accordingly.

(a) Role of Competition Law

It is beyond the scope of the paper to provide anything more than a glimpse of this important and complex area of law.[4] Suffice it to mention that institutions and principles are developed to identify and control the related phenomena of dominance in the market and its abuse and collusion between, or the merger of, competitors. As reflected in national and transnational legal regimes, opinions differ on the appropriate thresholds for defining unlawful conduct and the burden of proof. For example, one tradition regards it as sufficient that a single entity has a certain share of the market, while another focuses more on ascertaining the adverse welfare effects.

Competition is not, in all circumstances, the panacea for economic welfare. In some circumstances it is advantageous for production to be undertaken by one firm, rather than by several or many. The classic instance is where the marginal costs - and hence also average costs - of a single firm's production continue in the long run to decline, typically because fixed costs are high relative to demand (Foster, 1992). Although the standard undesirable consequences of such a "natural" monopoly may persist (goods being overpriced and underproduced relative to their true social value; productive inefficiency), the remedy lies not in competition. Rather the monopoly is allowed to prevail and some form of regulation is necessary to control those consequences. In the following sections, I consider the various alternatives.

[4] For a survey, see e.g. Furse, 1999.

(b) Public Ownership

In Europe, at least until recently, the most widely used regulatory form to control natural monopoly power has been public ownership. The expectation has been that the combination of political control and accountability, administrative *diktat*, and legal framework can best meet the regulatory goals.

Conventional industrial organisation theory can be used to predict that public corporations will have difficulty in achieving the same levels of efficiency as private corporations (Prichard and Trebilcock, 1987). There are no shareholders (residual owners) who are financially interested in the profitability of the public firm other than general taxpayers. Now, while taxpayers may voice their disapproval in the political arena, the losses are spread very thinly among them: as individuals they will therefore have little incentive to spend resources on political or legal action. Further, in the absence of profit-making incentives, the motivation of the managers of public corporations to meet consumer demand may be dulled. It is often assumed that public ownership is the appropriate regulatory form to accomplish objectives which are not economic. For example, on distributional grounds, it may be policy to provide some services to some sections of the population at lower than cost prices. But there is no reason why, under a suitably formulated statutory framework, these same obligations may not be imposed on private organisations.

Clearly if public ownership is the adopted form, attention must be given to the legal framework which is most likely to ensure that the public corporation performs satisfactorily its given role(Prichard and Trebilcock, 1987). The key components would seem to be: explicit legislative statements on objectives, powers and duties; clarification of the role (if any) of ministers in influencing the corporation's policy; systems of budgetary control exercised through independent public audit institutions; and accountability by means of residual powers of judicial review.

(c) Price and Quality Regulation

If the supplying monopolist firm is transferred into private ownership, there is a need to control the prices and quality set by the firm. The regulatory system can be envisaged as a long-term contract between the regulatory agency and the monopolistic firm with the latter agreeing to meet the reasonable demands of consumers at minimum cost in return for the agency allowing it

to charge prices sufficient to cover those costs. The primary aim is then for the terms of this "contract" to mirror what would have occurred in an unregulated competitive market.

The regulatory agency's task is a formidable one[5]. Difficulties arise from the fact that its access to information concerning the firm's activities is limited. It will not always be well placed to make decisions on whether the costs incurred by the firm were reasonable and thus to be covered by the prices set. Another difficulty is to determine a rate of return for the firm sufficient for it to be able to attract investors. Moreover, if the agency succeeds in setting prices just sufficient to cover costs, this will eliminate the incentive which firms in unregulated competitive markets have to earn higher than normal returns.

In addition it should be noted that many services and products which have natural monopoly characteristics form a part of a country's infrastructure and this may give rise to distributional concerns (Ernst, 1994) It may be considered desirable to ensure that the utility is available to all members of the community at a price which they will be able to afford. Given that the cost of supply will often vary significantly according to the location and other circumstances of the customers, this is not an outcome which would necessarily emerge in a competitive, unregulated market.

One possible solution lies in cross-subsidisation: a uniform price can be charged which enables the surplus of revenue from low-cost areas to finance supply in high-cost areas but this would seem to involve two disadvantages. First, the regulator responsible for reviewing the firm's prices, and hence the extent of the subsidy, will need access to data which enables him to verify that the subsidy is needed. Secondly, the relative transparency of the agency's price-setting processes may render the subsidy more visible and in consequence provoke opposition from low-cost consumers. Economists tend to suggest that it is preferable to charge customers according to cost, and fulfil the distributional aims by other means, for example, through social security payments (Foster, 1992).

(d) Competitive Public Franchising

An alternative method of regulating private monopolists is for the right to supply to be governed by a public franchise contract, which results from competitive tendering to acquire the right. The

[5] There is a huge literature on these issues. See, especially, Kahn, 1988.

terms of the successful bid, particularly those affecting price and quality, then become conditions of the franchise which, like any other contract, governs the on-going behaviour of the supplier. Contract thus replaces conventional regulation as the instrument of legal control and, unlike regulation which typically involves resort to, or a threat of, the criminal process, it relies on termination or non-renewal of the franchise as the principal sanctions for inadequate performance.

In theory, the ex ante competition for the monopoly right should force firms to supply their goods or services on terms which are consistent with economic efficiency and at the same time obviate the difficulties encountered by regulatory agencies in fixing appropriate prices (Demsetz, 1968). The agency will, however, still have to be confident that the financial structure of the firm is adequate to supply at the price bid. And there remains the problem of quality. The tender document must define the qualitative aspects of the service or goods supplied and the agency, in determining the outcome of the competition, should select the package of quality and price which, in its view, will best meet consumer preferences. That is not an easy task. Further, given the problems of defining and monitoring quality, there will be an incentive on the successful firm subsequently to reduce its costs by skimping on quality.

REGULATORY STRUCTURES AND PROCESSES

All regulatory systems require a number of tasks to be performed: as an exercise of policy-making, the goals of a regime must be established; those goals must then be translated into the principles and rules which control behaviour; and there must be procedures for explicating and enforcing the principles and rules and for the adjudication of disputes arising from them. Important structural issues arise in determining how these tasks are to be allocated to different institutions. The determination of an appropriate allocation of power contains dimensions both horizontal (the extent to which authority should be conferred on institutions other than the legislature or executive) and vertical (the degree of control exercised over such institutions). There are, in addition, key process values which assist in conferring legitimacy on the institutional structure and protect it from being diverted away from the public interest regulatory objectives; these include transparency and accountability.

(1) Regulatory Rule Making

(a) Centralised or Decentralised Regulation

Within a single jurisdiction, regulation can be more or less centralised and the same issue can be applied within an international context, given that within an economic of union of different states regulation may be harmonised (Bratton et al, 1996). For the purposes of exposition, assume that a federal state has different provinces. In general, regulation can supply to citizens different levels of protection at different prices, given that the cost of complying with regulation rises with its severity. If it be assumed that citizens across the federation do not have the same preferences, then there is a strong theoretical argument for decentralised regulation. Provincial lawmakers can more easily be informed about local preferences; and, should they reach decisions which do not meet those preferences, then citizens can move to another province where the package offered is more to their satisfaction. For their part, the suppliers of products or services subject to the regulatory controls can engage in trans-boundary trade or establish in countries where they are best able to satisfy consumer demand.

There are, however, obvious problems with this approach. First, it assumes that citizens are well-informed regarding the regulatory package, and alternatives available in different localities, and that migration is an easy option. Secondly, the regulation may have trans-boundary effects. Thirdly, provincial governments may come under pressure from their industries, who bear some of the cost, but none of the benefits, of regulation to override citizen preferences or exploit their lack of information. And if one province succumbs and reduces regulatory protection, the pressure on other provinces to do the same becomes all the greater

Regulation at a federal level can, in an idealised form, solve these problems. It will also have the beneficial effect of reducing the amount of law as to which those engaged in market transactions, whether suppliers or consumers, will need to be informed. But centralisation generates its own set of serious problems. It has to adopt what its lawmakers perceive to be the common denominator among regional preferences; and what emerges may in fact meet the preferences of only a small proportion of the greater population. Moreover, the very process of searching for the common denominator gives rise to problems of strategic behaviour between decision-makers and agreement will be difficult to obtain.

The above analysis suggests that neither exclusive decentralised regulation nor exclusive centralised regulation will be satisfactory. Some compromise between the two extremes is therefore called for. There should be a tendency to adopt harmonised federal regulation in areas marked to a significant degree by the following features: a homogeneity of preferences across the federation; serious transboundary effects; a strong likelihood, as a result notably of information problems, for provinces to engage in a race to the bottom. Where these features are not so significant, regulatory rule-making should be left at the provincial level.

(b) Differentiation in Rule-Making

There is a spectrum representing different degrees of generality of rule formulation. At one end of the spectrum, regulators may create a highly precise, perhaps quantitative, rule (e.g. vehicles must be driven at a speed not exceeding 30 m.p.h. in a given area); at the other end, a general rule (e.g. vehicles must be driven at a "reasonable" speed in urban areas), requiring interpretation by both the actor and the enforcement agency. Because a precise rule eliminates discretion and uncertainty, it reduces the agency's administrative costs and the power that the agency has over the regulated firm. On the other hand, its specificity means that it is inflexible and cannot be accommodated to the variety of circumstances to which it must be applied. It is likely to be over-inclusive (deterring more than is optimal in the circumstances) or under-inclusive (deterring less than is optimal in the circumstances (Ehrlich and Posner, 1974).

It follows that there are various legal methods of formulating differentiated rules (Baldwin, 1995b). The first option is to incorporate the rules into a formal regulatory code (normally parliamentary legislation or statutory instrument) which governs the activity. This renders the differentiation process more certain and more open to scrutiny, but it also makes change more difficult and liable to delay. The second option is for the regulatory code to contain a general principle, perhaps accompanied by guidelines as to how it is to be interpreted in particular contexts, but nevertheless conferring on the enforcement agency a broad discretion to differentiate according to the circumstances. Flexibility is achieved, but the exercise of discretion is unlikely to be open to public scrutiny and firms may be uncertain as to how the differentiation will apply to them.

The third option is to confer power on an agency to create formal differentiated standards for individual firms or groups of firms. The technique normally used is a system of permits: the legislation prohibits the activity unless the firm obtains from the agency a permit which contains

conditions incorporating the appropriate differentiated standard. This option combines the advantages of both precise rules and discretion: the rules are well defined and thus facilitate enforcement and compliance; and, at the same time, they may be tailored to the circumstances of each case. On the other hand, the system is, of course, very costly to operate - standards being individually negotiated - and, unless details of the permits are available for public scrutiny, vulnerable to manipulation and abuse.

(2) Delegated and Self-Regulation

As we have just seen, legislation, often only lays down general principles, delegating the power to make more detailed rules to other institutions. An important policy issue is whether such institutions should be government bureaucrats or rather specialised agencies, to some degree independent of government, perhaps even an agency representing those who are regulated

(a) Branch of Government or Independent Agency

Expertise can be concentrated and accumulated in specialised agencies in a way which is not always possible with government bureaucracies; and if the agency is also responsible for enforcement, that experience can beneficially feed back into the rule-making process. Further, distance from government may reduce the dangers of political interference, encourage a longer-term perspective and (perhaps) facilitate consultation and more open decision-making (Baldwin, 1995b).

Politicians may face the dilemma of having to placate powerful pressure groups with conflicting demands. They may recognise that a particular regulatory policy will benefit one group and impose costs on the other. A statute containing a vague principle may gain them the support of the first group, without incurring substantial opposition from the second group. The costs to the latter will become more apparent when the detailed rules are formulated; but, if this task is delegated to an agency, that institution, rather than the politicians, will bear the brunt of the criticism. Such a strategy will, moreover, be favoured by powerful pressure groups if they are confident that they can "capture" the agency for their own ends.

(c) Self-Regulation

There is a long tradition that the rights of practice, and the rules of conduct, for professional occupations are determined by bodies drawn exclusively or predominantly from members of the profession and in recent times forms of self-regulation have extended into other areas.

There are a number of arguments which suggest that, at least when applied to professional regulation, a self-regulatory agency (hereafter SRA) may be a cheaper and more effective rule-maker than a public, independent agency (Ogus, 1995). First, since SRAs can normally command a greater degree of expertise and technical knowledge of practices and innovatory possibilities within the relevant area than independent agencies, information costs for the formulation and interpretation of standards are lower. Secondly, for the same reasons, monitoring and enforcement costs are also reduced, as are the costs to practitioners of dealing with regulators, given that such interaction is likely to be fostered by mutual trust. Thirdly, to the extent that the processes of, and rules issued by, SRAs are less formalised than those of public regulatory regimes, there are savings in the costs of amending standards.

Of course, there are obvious objections notably that of the acquisition of power by groups which are not accountable to the body politic through the conventional constitutional channels. The capacity of an SRA to make rules governing the activities of an association or profession may itself constitute an abuse if it lacks democratic legitimacy in relation to members of the association or profession. The potential for abuse becomes intolerable if, and to the extent that, the rules affect third parties. And what guarantee is there that the regime will be devised and applied in the public interest, rather than that of the regulated group?

Recent developments have allowed for some mixture of “public” and “self” regulation, thus benefiting from the advantages of both systems. SRAs regulate with some oversight or ratification by government, or officials representing the public interest. In another version (Ayres and Braithwaite, 1992) a public agency negotiates with individual firms regulations that are particularised to each firm, with the threat of an imposition of less tailored standards if it fails to cooperate. The administrative costs of such a system must be high, suggesting that, for such a regime to be cost-effective, the firm must be large and the activity to be regulated must be one in which efficiency requires significantly differentiated standards.

(3) Accountability

We may usefully distinguish between three different forms of accountability (Loughlin, 1986). First, there is *financial accountability*: regulators should satisfy certain standards of financial management; they should minimise administrative costs and not waste resources. Secondly, their procedures must be fair and impartial (*procedural accountability*), such that there is an appropriate framework for making rules and decisions which serve the public interest and for resisting the undue influence of private interests. The third form, *substantive accountability*, is the most ambitious. It seeks to ensure that the rules and decisions are themselves justifiable in terms of the public interest goals of the regulatory system in question

(a) Financial Accountability

This aspect is almost self-evident and most countries have systems of public audit designed to ensure that public authorities and officials operate within their budget and spend resources only for authorised purposes.

(b) Procedural Accountability

Procedural accountability can be secured by the principles of administrative law which are commonly grouped under the heading of "due process" (Mashaw, 1985). Where regulators make decisions affecting individual persons or firms, such as the issuing of licences, they are usually subject to the natural justice requirement of a fair hearing. This requirement can be extended to other forms of regulatory rule-making, so that, for example, the regulators are bound to consult outside interests and to publish their proposals. Some are obliged to give reasons for their decisions.

Such procedures, it is often argued (e.g. Birkinshaw, 1996), encourage administrative rationality and thus lead to better rules, in the sense of facilitating adherence to public interest goals and constraining diversion to private interests. But it should it not be forgotten that “open” procedures generate substantial administrative costs and sometimes delays. They might serve to reduce inequalities in the power of pressure groups but, the closer the rule-making procedures are to adjudication, the more likely it is that the decision-makers will strive for outcomes which constitute a compromise between competing special interests that are represented in the proceedings; and that may force them to lose sight of a broader conception of the public interest.

(c) Substantive Accountability

There is, of course, no easy way of ensuring that regulation as promulgated fulfils, or at least pursues, its public interest goals. Certainly scrutiny by legislatures is unlikely to be effective. But experiments have been made with other devices, of which perhaps the most interesting is the regulatory impact analysis. Regulatory agencies, when preparing their rules, are in some countries required to issue a statement of the projected costs and benefits which the measure is likely to generate. This should at least impose some discipline on public officials to take account of the economic consequences of what they are doing (Froud et al. 1998)

Judicial review – the power of the independent judiciary to review the activities of public authorities – constitutes an important but also controversial instrument of accountability (Horwitz, 1977). Judges are well-equipped to assume the tasks imposed by procedural accountability. On the face of it, judges might also seem to be appropriate for monitoring substantive accountability. Their independence and autonomy, as well as the rules of the judicial process, should mean that they are insulated from political pressures to a greater degree than regulatory agencies. On the other hand, if the gates of review are opened too widely, the administrative costs of regulation may escalate and private interests will have an incentive to exploit the process for tactical purposes, thereby frustrating the implementation of public interest goals. Moreover, courts do not possess the expertise normally associated with regulators and the adversarial setting of the judicial process does not always lend itself to grappling with the range of problems encountered. (Fuller, 1978)

CONCLUSIONS AND RESEARCH ISSUES

In this paper I have sought to identify the main characteristics of "competent legal and regulatory institutions … and sensible regulation", such as are deemed by the Enterprise Development Department to be necessary to promote enterprise. In relation to particular developing countries, the research issues can be derived from these characteristics and summarised as follows.

- Regulatory regimes applying to specific sectors
  - **what are the justifications (economic or non-economic) for the regulation?**
  - **Is there a failure of the market and private law to reach the desired outcomes?**
  - **Are the legal forms used appropriate in the sense of being cost-effective and well-targeted?**

- Regulatory regimes generally
  - **Is there an appropriate degree of decentralisation and differentiation in regulatory rule-making?**
  - **Is regulatory administration delegated to appropriate institutions?**
  - **Are there appropriate systems of accountability?**

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