20. The Institutions of Regulation: An Application to Public Utilities

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1. INTRODUCTION

Regulation is part of the complex web of a nation's public policy. To understand regulatory design, then, it is imperative to understand the general determinants of public policy. The purpose of this essay is to highlight the usefulness of a transactional approach to public policy determination in understanding the origins, nature and the evolution of the institutions of regulation. As it merits an essay in a volume on the New Institutional Economics, we approach public policy as a (complex and often intertemporal) transaction among policy makers.[1] As such, the nature and features of public policies are impacted by the type of contracts facilitated by the institutions—i.e., the rules of the political game—of the country in question.[2] Here, then, we analyze the institutional determinants of regulatory policy making by looking at regulation as the outcome of complex intertemporal exchanges among policy makers. As in normal economic transactions, efficient intertemporal exchanges require safeguarding institutions. In their absence, we will observe the development of non-cooperative and short-term behavior, inflexible rules to avoid political opportunism, and in general low quality regulatory policies.

There are three basic types of regulatory equilibrium outcomes: public ownership, flexible regulation or rigid regulation. The type of regulatory outcome observed in a jurisdiction, then, is a direct result of the polity's ability to undertake complex intertemporal exchanges.

This approach, with strong intellectual underpinnings in the transaction costs approach as developed by Oliver Williamson,[3] places the emphasis on what Levy and Spiller (1994) calls regulatory governance, and less on regulatory incentives. They see regulatory governance as the mechanisms that societies use to constrain regulatory discretion, and to resolve conflicts that arise in

[1] This approach traces its roots to the path breaking contributions of the McNollGast team. See McCubbins, et al (1987, 1989).

[2] North (1990) separates institutions from organizations. Institutions are "the rules of the game" of a society, while organizations (such as firms, or legislatures) are formal structures with certain objectives, constrained by society's institutions.

[3] See, in particular, Williamson (1975), (1979), (1985), (1996).

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relation to these constraints.[4] On the other hand, regulatory incentives are the rules governing utility pricing, cross- or direct-subsidies, entry, interconnection, etc. While regulatory incentives may affect performance, a main insight from Levy and Spiller (1994) is that the impact of regulatory incentives (whether positive or negative) comes to the forefront only if regulatory governance has successfully been put into place. We go, however, one step further, and suggest that to understand regulatory performance we need to understand the institutional determinants of regulatory governance. In this sense, our neo-institutional approach to regulatory institutions differs from the two main strands of the economics of regulation literature of the last twenty years: the Chicago school and the incentives theory of regulation.

We differ from the Chicago School, as exemplified in the path breaking work by Stigler (1971), Peltzman (1976) and Posner (1971), in that, although rent seeking and distributional effects are important to understand public policy outcomes, we emphasize the institutional aspects that impact on the nature of regulatory institutions, and thus of regulation and sectoral performance. In other words, we believe it is important to open the black box of regulation. We differ also from the incentives theory of regulation, as developed following the path breaking work of, among others, Loeb and Magat (1979), Baron and Myerson (1982), and Laffont and Tirole,[5] in two main respects. First, we emphasize that the contracting schemes that are required to provide second best incentives are dependent on the institutional environment in which the firms operate. By developing the link between the institutional environment and the type of regulatory institutions that are feasible, we can, implicitly, develop the institutional conditions under which incentive regulation becomes feasible. Second, since the incentive theory of regulation shares the "black box"approach to politics of the Chicago School,[6] our emphasis on institutional determinants rather than pure efficiency incentives separates us also from the incentive theory of regulation.

Our emphasis in moving one step (or even two steps) higher in the hierarchy of issues not only makes us shift the object from regulatory policy itself (are prices closer to long run marginal cost, are mark-ups sensitive to cost changes),[7] to regulatory governance (are regulatory processes and rules to uphold those policies well established and stable?) and its link to the institutional environment that implements it, but also shifts the performance metric of analysis. Levy and Spiller (1994) emphasize that there are multiple regulatory regimes that are consistent with good performance. What is important, though, is that regulatory policy be stable, coherent, consistent across areas, predictable. In other words,

[4] Williamson would call such constraints on regulatory decision making "contractual governance institutions." See Williamson (1985, p. 35).

[5] See the summary of their work in Laffont and Tirole (1993).

[6] Observe that in most of the incentive theory of regulation literature, the regulatory process is described by a regulator's utility function. Interesting extensions into hierarchical or more dynamic models of regulation have brought some institutional flavors to this literature. See, for example, Demski and Sappington (1987), Baron and Besanko (1987) and Laffont and Tirole (1991).

[7] These are the object of analysis of the Chicago school and the incentive regulation literature.