

Four Approaches to the Political Economy of Regulation

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1. Introduction

1.1 One of the most important influences on the development of an insurance market and on the development of professions, such as the actuarial profession, is the nature of regulation. This paper looks at four main economic models of regulation. It draws on the analysis of Booth (1997) and Adams and Tower (1994). The ideas in this paper form a summary of some of the ideas in Booth (1997). The role of professions is crucially connected to the issue of regulation and we consider historical accounts of the development of the actuarial profession and the role of the actuary in Booth and Stroinski (1996), Daykin (1992) Johnston (1998) and Ferguson et al (1989).

1.2 This paper will consider the market socialist view in Section 2. Section 3 will discuss the “freedom with publicity” approach to regulation within a neo-classical economic framework. In Section 4, the “public interest” view of regulation will be analysed. In Section 5 we qualify public interest with the “public choice” theories of economics. Section 6 considers an Austrian view of the evolution of a market order. Finally, in Section 7, the role of profession and other sophisticated products of the market order are analysed.

2. Market Socialism

2.1 Although market socialism does not have an unambiguous definition, it could be defined as the situation where productive resources are owned by the state but where the state sets prices according to marginal cost. In other words, the state is trying to simulate the outcome of a free market. Market socialists maintain [see, for example, Lange and Taylor (1938)] that market socialism allows freedom of choice in consumption and occupation, with production being determined by demand prices and marginal cost. They believed that this would lead to a more efficient allocation of resources than a free market would because the central planning board would have a wider knowledge of conditions, consumer preferences and costs in the economic system as a whole than private transactors do in a free market. This approach contrasts with the neo-classical and Austrian approaches because, in the market socialist approach, it is believed that a central planning board can know better the costs and benefits of particular forms of actions than do individuals.

2.2 Market socialists therefore believe that governments should control every aspect of insurance markets (premium setting, product development etc.). Regulation would simply be an extension of this control.

2.3 In Western countries, this model of regulation has not been adopted. In broad terms, it is generally believed that individual transactors know best the information which relates to their situation and have the incentives to act on that information, and, in doing so, maximise economic welfare. However, it is worth summarising the market socialist position, partly because it is the antithesis of the Austrian approach to be discussed in Section 6 and partly because other approaches have elements (albeit minor elements) of market socialist thinking. Regulation often comes as a result of a perspective on behalf of the regulator, that regulators are aware of possible effects on third parties which participants in the market do not take into account.

3. *Freedom with Publicity*

3.1 In neo-classical economics, consumers are believed to react to prices and product quality and organise their consumption patterns in a way which is efficient, given their budget constraints. One of the product quality features that would be taken into account, in financial services, would be the security of the provider. As far as suppliers are concerned, they react to relative costs to find the cheapest method of supply. Under the standard assumptions of perfect competition, which include perfect information, this lends to the maximisation of economic welfare.

3.2 One approach to regulation is to ask which assumptions of perfect competition do not hold and seek to address these issues through regulation. Thus the argument runs, that, if there is imperfect information, this can be corrected by a so-called “freedom with publicity” regulatory framework which enforces the provision of certain types of information, such as actuarial valuations. If competition is imperfect due to imperfect information, then the intervention of the government, to ensure that information is provided, can improve the workings of the market, according to the “freedom with publicity view”.

3.3 Why might the provision of information be lacking? Adams and Tower (1994) discuss the role of regulation from the freedom with publicity perspective. They suggest that there may be inadequate incentives for market participants to provide information. This may be due to a lack of competition or because of an unequal possession of information amongst market participants and the ability of the industry to suppress information. Consumers also may not appreciate the importance of information until a catastrophe happens.

3.4 A freedom with publicity approach to regulation, where insurers are compelled to provide customers with certain information, is not a radical departure from a free-market approach. The sovereignty of consumers and the freedom of insurers is

acknowledged. However, regulation tries to ensure that individuals have sufficient information to take optimal decisions.

3.5 In the UK, insurance company regulation followed the freedom with publicity model quite closely until recently. That type of regulation also has a long history. The Insurance Companies Act 1870, for example, required the publication of regular accounts and actuarial investigations.

3.6 It should be mentioned that a freedom with publicity framework is not designed to minimise the probability of insolvency. Even in the presence of perfect information, consumers will make mistakes (and, as we shall see in Section 6, one of the functions of the market is to enable a learning process whereby people learn from past errors). Also, people may take risks which, ex-ante, may be quite rational. An insurance failure may cause consumers to re-assess the risks or regulators to re-assess the extent of regulation; however, an insurance failure does not provide a prima facie case for further regulation.

3.7 Information does have a cost. It should not be assumed, therefore, that the additional production of information is necessarily beneficial. Some have suggested [for example MacGregor (1996)] that the Financial Services Act 1986 involves an over-production of information at significant cost to the customer. As well as being costly, the over-production of information could undermine the ability of customers to distinguish between worthwhile and not worthwhile information and undermine the intermediary market, part of the purpose of which is to provide and interpret information.

4. *Public Interest*

4.1 “Freedom with publicity” looks at a very specific weakness in the market and tries to correct this weakness without too much intervention. The “public interest” view considers possible wider aspects of market failure and proposes that it is possible for a disinterested regulator to put those aspects of the market right, whilst behaving in the public interest. There are many reasons why governments may wish to intervene, particularly with reference to long-term insurance. These reasons were effectively articulated in the deliberations of the 1853 Select Committee of the UK Parliament, as discussed by Nicoll (1898). It was suggested by the Select Committee that, even if one accepted the general arguments pertaining to the free market, life insurance could be an exception for the following reasons:

- a) insurance relates to a long and uncertain period;
- b) it involves issues of an important and solemn character;
- c) a contract once entered cannot easily be revoked if the

solvency of the office becomes in doubt.

The other side of the argument was also articulated effectively. Adams and Tower (1994) suggest other reasons why governments may regulate in the “public interest”. There may be “externalities” or costs of insolvency imposed on those who were not party to a contract. This can happen if there is systemic failure within the financial sector. These issues, which lead to regulators acting in the public interest, could be jointly described as relating to “market failure”.

4.2 Adams and Tower (1994) also discuss the possibility of what is known as the “agency problem”. Because there is a divorce between ownership and control, it is possible that managers rather than owners objectives will be pursued within an insurance company. The authors report Boose (1988) who look at the life insurance market in New York. New York is tightly regulated relative to other parts of the US. It is suggested that the lower expense ratios reported in New York may result from the fact that regulation control substitutes for more expensive owner control. However, it will be seen in Section 5 that regulators themselves are not disinterested and may not work in the public interest. It is certainly not clear that the signals to regulators to act in the shareholder interest are stronger than those to managers.

4.3 There is no clear economic distinction between “freedom with publicity” and the “public interest” approaches. Both look for imperfections in the market, according to a neo-classical model of competition, and look to a disinterested regulator to correct those imperfections. However, when one considers the situation from a legal perspective, there are clear differences. Freedom with publicity allows a body of clear, stable and abstract law to develop which gives very little discretion to those framing and implementing the law. The law simply relates to the requirement for a body of information to be produced. If it is more generally accepted that the role of regulators is to correct deficiencies in the market, as the regulators perceive such actions to be in the public interest, there are no general principles by which regulators can operate. There is thus more incentive for law to proliferate finding more and more “special cases” which require regulations to correct perceived failures in the market.

4.4 There are serious weaknesses in the public interest approach. Just as markets can fail, regulators can fail both because they have imperfect knowledge (indeed, Austrian economists would argue (see Section 6) that the decentralised knowledge in the market could never be centralised in regulators) and because regulators will also pursue their own interests (see Section 5 on “public choice”). Also, the model, according to the Austrian viewpoint, fundamentally misunderstands the market process. The market’s outcome will never give the impression of being a perfect competition equilibrium. The market is a learning process which ensures that economic resources are allocated efficiently. Perfect competition is a model of

equilibrium conditions which will not exist in practice. It is a mistake to assume that, if the market out-turn differs in some way from the perfect competition model, it needs to be or can be put right by the actions of regulators. Furthermore, regulators ultimately act through signals transmitted through the political system which are likely to be far less perfect than signals communicated through the markets.

5. *Public Choice Theory*

5.1 In a neo-classical economic framework there is, in theory, a connection between success in promoting economic welfare and reward. There is no such connection as far as the development of regulation by politicians is concerned. In addition, regulators will lack knowledge, skills and be subject to inertia. They are also utility maximising individuals but do not necessarily have an incentive to act in the public interest. Regulators are ultimately accountable to politicians. Politicians may regard regulation as one of only a whole range of issues which voters would consider when deciding upon a politician's re-election. There are therefore few direct signals to a regulator to act in the public interest, even if he can perceive the public interest.

5.2 Public interest theory therefore needs qualifying. It will be inadequate in terms of its explanatory power because it fails to take into account the economic behaviour of regulators. Stigler (1971) proposed the economic theory of regulation. This suggests that regulation is an economic good and that the costs and benefits of regulation can be estimated and the extent of regulation be determined by supply and demand. Supply and demand for regulation (in the form in which it is referred to) takes place through the political system not through the market. The economic theory of regulation is more complete than public interest theory because it considers the forces which give rise to regulation and analyses the motives of regulation. However, the economic signals and economic motives which are transmitted through the political systems are not the same as those which take place through the market: the term "economic theory" is therefore possibly inappropriate. These ideas are best discussed under the headings of "public choice" (which analyses the behaviour of regulators and politicians in bureaus) and "capture theory" (which looks at how the regulatory process can be captured by interested parties).

5.3 The public interest theory suggests that the regulatory bureaus will be supplying regulation which cannot easily be supplied by voluntary contract in the market. Theoretically, it should be possible for the regulators to perform an economic "cost benefit analysis" of regulation in determining whether it should be deployed. However the bureau is a monopoly supplier of regulation and regulators will have their own utility function. There are therefore many ways in which the political system will fail to provide the economically optimal amount of regulation. There is asymmetry of information. Those supplying regulations can find it easier to dominate

argument through the political process because of their access to superior information. Even if the aims of the regulator are benevolent, he will not necessarily understand the preferences of the individuals on whose behalf he regulates the market. He also cannot simultaneously satisfy all the preferences of consumers who will have different propensities to take risks. There may also be no effective controls on the costs of regulation as a bureaucracy proliferates more regulation.

5.4 Public choice theory also considers the behaviour of voters. Traditional economics tries to understand the outcome of a competitive market under certain assumptions. Public choice economics looks at the provision of publicly provided goods (such as regulation) under different voting systems. Such public choice models predict over-regulation. This is partly because the benefit from over-regulation is concentrated in a particular group (that of regulators) and the political process does not effectively ensure that the preferences of the dispersed majority of voters who would benefit from less regulation are enacted. The dispersed majority of voters may lose out from regulation but they would lose out to a lesser degree, as individuals, than the concentrated interest group would benefit.

5.5 Thus, in public choice economics, the benevolent, far sighted regulator is replaced by a self interested regulator who may be unwilling to act in and is unable to know the public interest. The dispersed and non-uniform preferences of transactors in the market prevent all their preferences being satisfied simultaneously. These ideas clearly add something to neo-classical analysis. They also indicate that, if it is possible for the services that regulators provide to be provided through the market (for example through the professions), this may be preferable.

5.6 Another aspect of the economic analysis of regulation is “capture theory”. Capture theory predicts that the political process is dominated by interest groups who can “capture” the regulatory process. Very often the capturing groups may be producer groups as they are often more concentrated, have a common identity of interest and are economically more powerful than dispersed consumers. Regulations may therefore be developed for the benefit of existing producers although the justification, used by existing producers, for that regulation would, on the whole, be consumer protection. For example, capital requirements could be justified on the grounds of consumer protection but may, simultaneously, restrict entry to the market. Regulations can also be captured by professional bodies who may seek statutory monopolies over certain areas of activity. Johnston (1989) describes the role of the Appointed Actuary in the UK. The Appointed Actuary system gives the actuary certain statutory roles. However, Booth (1997) reviews whether this provides evidence of capture. He concludes that there is not significant evidence. For example, Booth draws on *The Future of the Profession* (1996) in which it is stated that, “Competition must be welcomed and met. It is the last resort of any profession to rely on statutory requirements to maintain its position.” Regulation can also be

captured by the regulatory bureaucracy itself which can create rules and enforcement procedures which maximise the economic objectives of the regulatory body rather than of market participants.

5.7 All these issues could be summarised as constituting regulatory failure or government failure in trying to correct market failure. The early regulation in the UK (1870-1970) did not show any evidence of capture or other public choice elements. Since that time (for example in the Insurance Companies Act 1982, Financial Services Act 1986 and Pensions Act 1985) regulation has become increasingly prescriptive and expensive and there is evidence of possible bureaucratic capture.

5.8 Thus, in summary, there is a sense in which public interest theory suggests that regulators should correct deficiencies in the market to move it closer to the outcome which would be achieved in a theoretical model of perfect competition. Public choice theories however consider the reality that regulators do not have perfect foresight and may act in a way which maximises their own economic utility. The Austrian framework, considered next, looks at the dynamics of the market in a different way. It emphasises different issues from those emphasised by the neo-classical framework and, therefore, comes to different conclusions.

6. Austrian Economics and the Evolution of a Sophisticated Market Order

6.1 Austrian economics demonstrates that it should not be assumed that an unregulated market will break down into chaos. Instead, a complex order will develop. That order will be imperfect but it may well contain sophisticated structures which protect consumers. The structures exist because they add value to transactions in the market. This leads to certain questions when considering the extent to which regulation is necessary. Is there evidence of such structures having evolved? If there is, what form have they taken? What role is there for professional responsibility and on what principles should regulation be based?

6.2 Austrian economics very much reconnects the different disciplines of philosophy. There is a good summary of the main ideas in Hayek (1982), Hayek (1960) and Kirzner (1997). The market and competition are regarded as information gathering, and assimilating structures and processes. A market never reaches the stage of an idealised model such as that of perfect competition. Market exchange is a constant process of trial and error in which the incentives exist for better practices to survive and for failing practices to die out. Incentives and information are communicated through the price mechanism. Furthermore, the knowledge about costs and preferences of producers and consumers is naturally dispersed and subjective. It is not possible, in this model, for a regulator to know and centralise the necessary information to improve on the workings of the market, through detailed regulation.

6.2 Two further aspects of this school of thought are worth emphasising because they have implications for regulators and market participants. With regard to market participants, the importance of the market being a learning process is critical. We can expect mistakes to arise in a dynamic market in the absence of perfect knowledge. Sometimes, these mistakes may be catastrophic. The market does not fail if mistakes arise. They are a crucial part of the learning process by which participants in the market satisfy their preferences better. Regarding regulators, it should be pointed out that the Austrian school would maintain that the detailed economic effects of our actions can rarely be foreseen. This does not matter in a free economy which develops its own spontaneous order from a constant process of trial and error but does matter in a regulated system, where what is frequently known as the “law of unintended consequences” applies. This again suggests that detailed regulation may fail. The market consists of millions of individuals, all of whom have differing degrees of knowledge and different preferences for risk. It would not be possible to determine in advance what type of regulation will satisfy preferences better. Austrian theorists would have much sympathy with the comments of Bank of England (1996) that, “Heroic attempts have been made by academics to measure the costs of regulation: quantifying benefits is even harder. It may be more fruitful to focus on the issues which regulation is attempting to address and consider whether there are lower cost ways of addressing them”. (page 468). Thus detailed cost benefit analysis of regulation discussed under economic theories, may be unrealistic. Indeed Hayek (1982) says that, “Nor can the choice of the appropriate set of rules be guided by balancing, for each of the alternative set of rules considered, the predictable favourable effects against the predictable unfavourable effects for most effects on particular persons of adopting one set of rules rather than another are not predictable”. (Volume 2, page 3). However, from considerations of general principles, Austrian theorists would contend that a lightly, regulated market, which allowed competition, innovation and entrepreneurship will satisfy consumer preferences better than a tightly regulated market.

6.4 In interlinking the disciplines of law and economics the Austrian School would also consider the legal structures in which regulation should take place. Firstly, administrative discretion is regarded as dangerous because it can cause rules to proliferate; it centralises power and prevents individuals from following their own objectives; it leads to uncertainty as to the rules under which trade takes place; and there are no clear lines for accountability. Thus rules should be of a general or abstract kind.

6.5 As has been stated, Austrian economists do not believe that a lightly regulated market will descend into anarchy. In fact, they stress the richness and diversity of market institutions in an extended order (see Hayek 1988). The competitive market does not consist of large numbers of producers producing similar products and large

numbers of consumers seeking the lowest price, as textbook competition models suggest. Not only will consumers look at product quality and risk and insurer risk when deciding what to buy, more importantly sophisticated institutions can develop in a market which will add value for market participants. This is part of the discovery process in the market; sophisticated institutions will evolve as a result of market participants discovering their value. These institutions can perform many of the functions that might otherwise be performed by regulation. We now look at the reality of whether such institutions do exist.

7. Evolving Institutions in the Market

7.1 Austrian economic theory suggests that complex economic structures can develop within a market in order to satisfy the needs of consumers. Those needs include the need for security, so it is of interest to ask if structures have developed within the market to perform some of the functions which are performed, perhaps less adequately, by regulation, in particular the provision of security.

7.2 Firstly, professions have a role. Professions, such as the actuarial profession, owe their duties to the professional body as well as to a commercial organisation. Commercial organisations gain economically by employing professionals because they can demonstrate that consumer interests are partially protected by a professional who is both trained to be competent and has to abide by a code of professional ethics. Booth (1997) reviews evidence which suggests that the actuarial profession in the UK developed in the sophisticated way it has because it operated in a lightly regulated market.

7.3 There are a number of other institutions of the market which have evolved to meet some of the concerns expressed by the 1853 Select Committee (see Section 4). In the nineteenth century, many of the insurance needs of those on lower incomes were provided by Friendly Societies and Mutual Companies. These can appear economically inefficient. However, one possible explanation for their development is that consumers are more comfortable with organisations providing long-term insurance where the interest of the providers of capital is not separated from the interests of policyholders. Intermediary markets also developed to assist consumers in their purchase of financial products. The complex and long-term nature of life insurance makes its analysis difficult and time consuming for consumers. An intermediary market can perform the information gathering role effectively and efficiently. A modern development is the evolution of credit rating agencies which, possibly more effectively than regulation, can assess the solvency of financial institutions and give those institutions a public rating. The rating is easier to understand than any published valuation figure and derives from a full analysis of the financial situation of the company by experts.

7.4 Thus there are structures which will evolve in the market which are orientated towards the same type of objectives as those to which regulation is orientated. There are lessons here for both regulators and professions. Public choice theory suggests that the functions of regulation should be limited, and talks about the dangers of regulatory capture. Austrian analysis would suggest that the market is capable of evolving institutions which will perform, better than regulators can perform, many of the functions which are often centralised in regulators. The centralisation of those functions within regulatory authorities can stifle the development of those market institutions.

7.5 The professions, in particular the actuarial profession, must be aware of their role within the market. In the UK, this is a pivotal role and a great deal of trust is placed in them. There are at least three aspects of the work of the profession that are essential. Firstly, an effective and adequate education system to maintain a given level of competence. Secondly, a code of professional conduct laying out the responsibilities of the actuary. Thirdly, a disciplinary procedure. It is important to appreciate that the profession is a product of the market and that its main responsibilities are not statutory responsibilities. A profession which seeks statutory responsibilities, in the long run, can become weaker, not stronger.

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SYSTEM REQUIREMENTS:

The minimum system requirement to run this software is:

Microsoft® Windows®, version 3.1 or higher
IBM-compatible (Pentium 100 MHZ or better)
CD-ROM play (2X or better)
Sound card (SoundBlaster Pro or compatible)
640K plus 8MB extended memory
A hard disk with at least 7MB of free disk space
SVGA Windows-supported graphics monitor
A Windows-compatible mouse or other pointing device

INSTALLATION (Windows® 3.1x)

Start Microsoft Windows® 3.1X
Insert CD into your CD-ROM drive
Open the Program Manager
Bring up the dialogue box [click on "File"; click on "Run"]
Type the CD-ROM drive letter followed by a colon and a backslash (\:)
Example: If Drive = D, type "D:\\" (no quotes)
Type: SETUP and press ENTER

Follow the directions on the screen
The following things will happen:

1. The program is installed in a directory on your hard disk
2. The default directory is "C:\ARC_32"
ARC = Actuarial Research Conference
3. A group is created in Program Manager
The title of the group is "ARC32_20"
The group is "ARC3220.GRP"

RUNNING THE PROGRAM

The following things happen when you install this software: (see INSTALLATION for installation directions)

To run the program:

Restore the Program Manager, if necessary
Double click the "ARC32_20" icon
Alternately, click the "ARC32_20" icon and click "Restore"
Double click the "ARCH 32_20" icon

INSTALLATION (Windows® 95)

Start the computer, Windows® 95 appears
Insert CD-ROM into your CD-ROM drive
Click the Start Button at the bottom of the screen
If the Start Button doesn't show, move cursor to screen bottom
Clicking Start reveals a menu

Select "Run" on the menu
In "Run" dialog box type CD-ROM Drive letter, a colon and backslash
Example: If Drive = D, type "D:\\" (no quotes)
Next type SETUP.exe and press ENTER
Result: directions appear. Follow them.

The program installs

The following things happen will happen:

1. The entire program is installed in a directory on your hard disk.
2. The default directory is C:\ARC_32
3. A group program is created in "Program," on the menu that "Start" reveals.
4. The title under the group is ARC32_20