This is a stimulating paper, but also one that is difficult to read, to digest, and therefore to comment on. It is stimulating because it contains many new ideas, and some very provocative thoughts. It is difficult because it deals with something that cannot easily be observed and measured: regulation; it is difficult also because it does not propose a formal model to which the reader can hang on.

The paper proposes a framework for looking at regulatory activities. Although some of the arguments advanced here can be found in the public choice literature, Professor Kane does a brilliant job at building his case. His main message is that we can apply economic criteria to look at regulatory activities, and indeed that regulators obey the same economic laws as most other economic agents. Moreover, regulation is often a two-way street; while regulated firms obviously are under the influence of their regulators, these also depend on the firms they regulate if they want to survive in the regulating business.

Regulatory forces and market forces are interrelated. Market forces often induce regulatees to find a way to get around regulation, and regulation must take into account this form of avoidance behavior. Thus, we must view both “the shape and ultimate effects of regulation as endogenous economic variables” (my emphasis). This is a very ambitious and admirable goal; unfortunately, the paper falls short from proposing a formal way for achieving this.

Clearly, regulation is an activity which has expanded tremendously over time. One of Professor Kane’s contributions is to draw our attention to this important “industry” which seems to absorb ever increasing amounts of real resources. Most of us here would agree, regulation is required, unless we adopt the extreme view that the economy is best left to itself. As soon as we allow for externalities, public goods, and departures from perfect competition, we must envisage some form of regulation. But what we tend to forget, is that sometimes regulation takes on a life of its own, and that regulators may regulate for the pleasure of regulating.

Although Professor Kane focuses on regulation in the financial service area, and his examples concern the FSLIC and the BIS in particular, his analysis can be applied to a wide variety of regulating agencies. Almost any form of government intervention, any public policy can be viewed as some form of regulation. Be it monetary policy, commercial policy, fiscal policy, farm policy, health policy, transportation policy, energy policy, or environmental policy, they all impact on the behavior of the public. Government agencies regulate almost everything, from the operation of financial markets to the operation of elevators and cable cars, from the contents of the food we eat to – at least in

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Europe – the contents of the TV programs we watch. Sometimes, this is for safety reasons, sometimes for efficiency considerations, and sometimes for equity reasons (or, to be more blunt, to promote the welfare of a particular group of the population).

Regulation need not be a public activity: there is room for private regulators. Examples include stock markets in some countries, trade associations and hotel franchises, just to name a few. Regulation provides a service that may lead to economies in terms of information costs and transaction costs. Regulators monitor, discipline, and coordinate the behavior of the regulatees. However, this service may be produced by another agent, perhaps at a lower cost. Thus, there is often scope for competition.

Regulators may seek to increase their market shares. This is obvious in the private case, such as the hotel or restaurant franchising business, or the sport area (the International Olympic Committee is an example of a private regulator which has done extremely well for itself). But there may be competition among public regulators as well, such as between local tax authorities, between competing government agencies, or at the international level, in the area of commercial shipping, for instance, or between financial authorities of different countries. Naturally, it is not because there is room for competition that there is necessarily perfect competition. On the contrary, there may be many distortions, and barriers to entry and to exit. In the presence of externalities, such as in the environmental area, excessive competition may be undesirable as it can lead to a reduction in safety and to an insufficient level of protection.

The regulating industry, much like any other industry, pursues its own objectives, subject to some technological and institutional constraints. Yet, maybe more so than for other industries, there may be conflicts between individual objectives and overall efficiency. Conflicts of interest exist between the interests of the public at large, the interest of the producers and consumers of the regulated product, or the own personal interests of regulators. One major problem is that regulators are often not accountable to taxpayers (or voters). They ought to act in the “public interest”, whatever that means (the public at large might be defined to also include foreign residents). Instead, they very often act in the interest of a narrow constitution - to which they may be accountable - and sometimes to promote their own welfare.

Such conflicts of interest may be particularly unfortunate during periods of crisis. Thus, blowing the whistle does not pay. AS WALTER MONDALE found out, the public often does not like bad news, and may be tempted to kill the messenger. Regulators therefore have a tendency to hide it, to cover it up: this can be characterized as the “don’t worry, be happy...” philosophy.

Some regulators have a hard time to justify their existence. Regulators do not die gracefully. To survive, they must desperately find new tasks; not surprisingly they tend to be very secretive about their activities, and they like to treat much of their work as confidential.

The paper presents a framework for looking at regulation, but no formal model. One cannot help but wondering what such a formal model would look like. If for nothing else, such a model might be helpful in attempting to determine the optimal level of regulation.
One obvious difficulty in formally modeling regulatory activities is that the amount and the quality of regulation are difficult to measure. Another problem is that regulation is often not sold in the marketplace; thus it is difficult to observe the price of regulation. However, these obstacles are not insurmountable, as the literature on public goods and externalities demonstrates.

What I would have like to see is a model of the provision of regulation; regulatory services can be produced by a production or a transformation function. Regulation requires scarce resources, such as labor, capital and paper, and it is undertaken to maximize some objective function. Next, regulatory services enter the technology of the regulated firms; it can be as an input (private or public) that facilitates the conduct of business; alternatively, or simultaneously, it can be as an output, since regulation can impose a cost on the industry. Deposit insurance, for instance, facilitates business, and attracts customers, but it also imposes some restrictions on the firms. If the firms have any say in the matter, the benefits must outweigh the costs.

This approach could be tied to two bodies of the literature which are rapidly expanding. On one hand, there is the new growth literature that emphasizes, among other things, the role of public inputs, and more generally institutions, in the production and the growth process. Second, there is the production theory approach to the provision of financial services. This approach, which views the production of financial services like the production of any other type of good or service, can be used in empirical work, and indeed, it has been applied fruitfully in recent years to both the banking and the insurance industries.

The paper often conveys a somewhat cynical view of regulation. Certainly, regulators like to maximize their own welfare, be it a function of income or of influence. They may want to stay in office, or win a new term. Or they may want to be remembered as good regulators, perhaps in order to enhance their future job prospects. However, I would like to end on a positive note, and to emphasize what Professor Kane himself concedes in the introductory part of his paper, namely that there are many selfless and dedicated regulators, civil servants in the true sense of the word, who honestly and tirelessly labor in the “public interest”.