REGULATORY CAPTURE IN THE CONTEXT OF THE IRISH REGULATORY FRAMEWORK

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Niamh Callaghan looks at the overall regulatory framework of the transport sector in Ireland, and reveals how prone it is to regulatory 'capture' by interest groups who often compete with each other to do so. She also demonstrates the benefits that have accrued from deregulation, for example in the Irish taxi industry, despite the resistance to embrace competition on the part of Irish regulatory authorities.

Introduction

Economic regulations intervene directly in market decisions such as pricing, competition, market entry and exit. Reform aims to increase economic efficiency by reducing barriers to competition and innovation, often through deregulation and the use of efficiency-promoting regulation (OECD, 2011). The quality of regulatory decisions impacts upon Ireland's competitiveness, which is so crucial to our economic survival at present and the welfare of Irish consumers (Gorecki, 2010). The transport sector has a particularly important role in our economy and has traditionally been highly regulated. Thus an investigation of the way such regulatory actions are implemented is a necessary task.

Regulatory capture is a real threat due to the number of different parties in this industry with competing motivations. Regulatory capture is defined as a situation in which one operator (or group of operators) in the market uses its influence or resources to extract a regulatory decision, or lack of decision, for their own benefit rather than the benefit of society as a whole (Department of the Taoiseach, 2004). In this essay, an outline of the theories of regulatory capture will be provided to create a platform on which to discuss the functioning of the Irish regulatory framework. Using examples such as CIE, the existence of this problem in Ireland as well as some success stories will be highlighted.

There are many arguments for regulation, both economic and social. The main economic reasons for regulation are to guarantee the provision of a service, to act as a counterweight to market power, to tackle externalities and to correct information asymmetries (Turnbull, 1999). Sometimes these arguments can be conflicting, reflecting the ongoing trade-off in economics between efficiency and equity. Regulation in the transport sector has traditionally been justified by the belief that in its absence the market would under invest in transport services, particularly in peripheral areas. The evidence does not support this argument as the bulk of investment in transport is undertaken by the private sector (Barrett, 1990).

Capture Theories

The 'capture' or 'interest group' theory concentrates on the role interest groups play in the formation of public policy. Information asymmetries must exist between businesses and the state to create an incentive to influence the behaviour of public institutions (e.g. regulators). Interest groups have a stake in the behaviour of state agencies which regulate them therefore independent oversight is crucial to responding to potential collusion between the two parties (Harrington, Vernon and Viscusi, 2005).

Stigler (1971) posits that conflicts of interest occur in all aspects of life but the fight is fairer when played out in the market place as opposed to the political arena. Market decisions are instantaneous and carried out by all participants as demand reacts to supply. In politics, decisions are made infrequently and by elected representatives to reflect the global good but in reality this system is open to manipulation. This analysis goes to the very core of the decision to place regulation in the hands of a few rather than leaving the decision with each individual in the marketplace.

Pioneering work by Stigler (1971) and later expanded by Peltzman (1976) helped to develop a theory to explain the occurrence of regulatory capture. The three main points outlined by the two authors were that: regulatory legislation is first and foremost a redistribution of wealth; the behaviour of legislators is motivated by their desire to remain in office implying that legislation is designed to maximise political support; and finally, interest groups compete by offering this political support[1]. The conclusions drawn are that better organised and funded interest groups will exert the most influence on regulatory bodies. Furthermore, they will benefit more from the gains from favourable legislation and will thus be willing to invest more resources into making capture possible. In particular, regulation will benefit small interest groups with strongly held preferences to the detriment of large interest groups with weaker preferences. This insightful argument put forward by Peltzman (1976) reinforces the empirical evidence that regulation tends to be pro-producer. Firms, due to their smaller size and the importance of profits,

[1] The political element referred to above does not merely include support from political parties or institutions but perhaps funding and support from private sectors.

will be more likely to 'capture' the regulator rather than the very large group of consumers with a much smaller interest in the regulation of one particular product or service which they consume[2].

Another model, proposed by Becker (1983), focuses on the competition between interest groups to become the 'capturer'. This model dismisses the role of the regulator and assumes that regulation is used to increase the welfare of the most influential interest group. The political equilibrium resulting from this model is Pareto inefficient[3] and as with all cases of capture, results in a large waste of resources.

Another reason a regulatory agency may be guilty of capture is due to the effect public and private interests have on the survival of regulatory officials and the agency's budget. A regulatory agency can have an interest in the success of the industry they are regulating and may thus be tempted to act more in the interests of the industry rather than the public[4]. A further issue is the funding of regulatory agencies. Agencies are often funded by a levy on the regulated firms which may be passed onto the consumer (Gorecki, 2010).

Costs of Inefficient Regulation

The stakes involved in regulation are very high. There is a trade-off between having regulation, which can lead to gross inefficiencies if not correctly implemented, or no regulation which can also lead to inefficiencies and a waste of resources in the form of monopoly profits and a deadweight loss for society. For instance, Winston (1998) estimated that the gains to passengers and companies from deregulation in the transportation field are $50 billion per year. This was a sizeable cost levied on consumers prior to deregulation.

The late Alfred Kahn (1971) notes that regulation contains no built-in mechanism to ensure efficiency, despite its purpose as a device to improve market conditions and remove inefficiencies associated with the conduct of monopolies[5]. Regulation restrains companies from fully exploiting their potential monopoly power. Thus, their incentive to operate efficiently is dramatically reduced as the supernormal profits which previously motivated them have been eliminated. Regulation can cause the alteration of the behaviour of the regulated firms in order to lessen the impact of the regulation on their profits incurring a further waste of resources.

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[2] An example of this is illustrated later in the essay.

[3] Both groups could invest fewer resources and still achieve the same level of relative influence but, similarly to Nash equilibrium in the prisoners' dilemma game, no party will wish to deviate from this outcome even though it is inefficient.

[4] Such an interest may include a requirement in its brief that it should promote the industry, e.g. this occurred in the Irish financial industry much to the detriment of the banking system and the economy of this country.

[5] A higher price is charged to consumers and a quantity below equilibrium is supplied.

The costs of regulation are numerous and may not appear obvious at first glance. Regulation imposes a burden on businesses[6], directly and indirectly. Often firms are charged a levy to fund the activities of the regulator[7]. Other direct costs include compliance costs, encompassing employee training and efforts to understand and implement the rules, claims on management attention, discouraged investment and lost producer and consumer surplus from reduced output (Harrington, 2006). The initial costs of compliance are by no means the end of the story; there are many indirect effects on innovation and productivity which can be very damaging to the effected industry and the economy as a whole, as consumers are denied new and improved products or levies imposed are passed onto them in the form of increased prices (Hopkins, 1995). Furthermore, the costs of rent seeking[8], including the unproductive activities undertaken by firms and individuals when trying to influence regulatory decisions, should also be considered. Thus the costs associated with regulation are much larger than first thought. Posner's (1975) paper shows an economic model of the social costs of monopoly and he concludes that the costs are most likely higher in the regulated, as opposed to the unregulated, sector of the economy.

Regulatory Capture in the Irish Transport Sector

The Organisation for Economic Co-operation and Development (OECD) published a report in 2001 detailing the history of regulation in Ireland and the reforms which should be implemented in the future (OECD, 2001). The report highlights the existence of regulatory capture in Ireland and its effect on impeding economic progress. It points to a lack of clear priorities or strong incentives to transform deep-rooted regulatory traditions and practices as the reasons for lack of reform. The report acknowledges that significant progress has been made in some areas but further action must be taken to prevent regulatory capture, including reducing the influence of informal processes that provide opportunities for interests to monopolise information and thus favour 'insiders' (OECD, 2001).

Improving transparency is proving especially difficult, due to rent-seeking attitudes and the close relationships between elected representatives and producer interests, which generally act against free market principles and the interests of consumers. Consultation processes on reforming local transportation systems in particular have garnered much criticism for being greatly influenced by interest groups.

[6] This burden has been the subject of much debate in the US following President Obama's introduction of many new rules and regulations. Some have argued that the increase in red tape has caused the President to be labeled as 'anti-business' by some agents in the economy (The Economist, 2011).
[7] The National Transport Authority is funded by the state which also provides the subsidies to CIE.
[8] The opportunity to capture monopoly rents provides firms with an incentive to use scarce resources to secure the right to become a monopolist. Such activity is referred to as rent-seeking. Rent-seeking is normally associated with expenditures designed to persuade governments to impose regulations which create monopolies (OECD, 2011).

The Commission for Aviation Regulation (CAR)[9] has been successfully captured, as a result of Ministerial Intervention, by the Dublin Airport Authority (DAA), whom it was meant to regulate. CAR imposed price caps which were ignored by the DAA, resulting in the earning of supernormal profits (Commission for Aviation Regulation, 2008). The breach of the price caps incurred no rebuke for the DAA, thus allowing the behaviour to continue and other parties, namely customers, to suffer.

The government considered allowing private contractors to build and manage an independent Terminal 2 at Dublin airport, a premise strongly supported by Ryanair. However, this move was resisted by the DAA due to their desire to retain their monopoly position at the airport. The government then decided that the DAA would build the terminal but the contract for its operation would be put out to tender. There was yet another u-turn in March 2010 when the DAA were announced as the operators amid claims that other applicants did not meet the requirements for operating the terminal (Ryanair, 2005). These events clearly demonstrate the power wielded by the DAA over the government. The DAA now operates both Dublin airport terminals eliminating the possibility of competition between the two and potentially keeping charges artificially high.

Alternatives to Regulation

There are many economic benefits associated with the private ownership of real assets. With privatisation, a market of corporate control is created. The threat of bankruptcy, which is absent from nationalised firms, is a strong motivating factor for ensuring efficiency. The market, through Adam Smith's (1776) famous 'invisible hand', will evaluate the performance of management. In contrast, ministers and government departments cannot objectively assess the efficiency of a nationalised firm under the bind of regulatory capture. The remedy of market failures can rarely be undertaken without the creation of gross inefficiencies (Barrett, 1990).

Furthermore, not all markets with a dominant firm may be inefficient and require regulation. The theory of contestable markets (Baumol, 1982) states that the threat of potential entrants can be sufficient to ensure a firm behaves in a competitive manner[10]. The extent of freedom of entry should be considered in this assessment. Also, when competition within a market is not possible there may be scope to instigate competition for the right to operate in the market (Demsetz, 1973). This method may be useful in the case of natural monopolies, where due to economies of scale, it is irrational to have more than one firm. Competitive tendering is used successfully in the air traffic control industry to reduce costs (Barrett, 1990).

[9] CAR now falls under the remit of the National Transport Authority (NTA)
[10] The firm does not earn economic profit in the long run and that the long run price is equal to marginal cost.

It is very rare that a nationalised firm would pay dividends to the Exchequer indicating that inefficiencies prevail, thus providing evidence of the spiralling costs associated with state-owned companies. For example, CIE made a loss of €77.7 million euro in 2009 (CIE, 2010).

Success of Deregulation

Airline deregulation occurred on all Ireland and UK routes in 1986. It resulted in the reduction of fares by up to 54% on the Dublin to London route and an almost doubling of capacity. Furthermore, the number of tourists visiting Ireland increased three-fold from 2 million to 6 million (Barrett, 2003b). This is an example of a very successful liberalisation of the market resulting in gains for the industry in terms of increased efficiency, the consumer in the form of lower prices and the economy as a whole.

Deregulation in the Irish taxi industry occurred in 2000 despite constant pressure from incumbent taxi license holders to maintain the old regime. In the period 1978-1991, the number of taxis in Dublin remained relatively constant at approximately 1,800 (Barrett, 2003a). Considering the large economic growth in this period, these figures are startling and tell the story of a stagnant industry devoid of reform. The incumbents managed to successfully delay deregulation and to frustrate the Irish consumers for over thirty years due to their claims that safety levels would drop, their incomes would be depressed and a devaluation of licenses would occur. These arguments eventually proved unfounded and the results of deregulation have been overwhelmingly positive for consumers and new market entrants. The number of taxis soared following the judgment in 2000 proving that demand was not being met. However, incumbents remain unhappy with the decision and have once again attempted to capture the regulatory authorities by staging a series of strikes, poster campaigns and lobbying trade unions. As a result of these actions a Taxi Hardship Panel was set up to analyse the effect of deregulation on the livelihood of those taxi drivers whose licenses considerably diminished in value following deregulation (Barrett, 2003a). It is open to debate whether the formation of this panel constitutes regulatory capture but it appears that the price for a license was artificially high before deregulation and the current price reflects the equilibrium market price formed by the interaction of supply and demand. Barrett (2003a) considers this change in value analogous to an investment which is open to market fluctuations. It must be emphasised that some of the advantages of deregulation will accrue in the long-term and thus the success (or failure in some groups' eyes) should be analysed in a long-run context (Winston, 1998).

Regulatory Reform in Ireland

Reform of regulation in the transport sector has to be addressed immediately due to its extreme importance. Due to our location on the periphery of Europe, transport is vital to our export dependent economy. Low transport costs are vital to improving our competitiveness. The OECD (2001) recommends the removal of licensing restraints throughout the economy, particularly in the bus industry and at ports. Further potential changes include the increased representation of consumer as opposed to producer interests during policy discussions.

A Government Statement on Economic Regulation (Department of the Taoiseach, 2009) announced the creation of a single transport regulator, the National Transport Authority. It encompasses the Commission for Taxi Regulation, the Commission for Aviation Regulation and the Irish Aviation Authority. This statement also outlines increased powers for ministerial oversight in respect of regulatory agency. Although an increased surveillance is on the surface a positive action, ministers are more prone to being 'captured'[11]. Furthermore, the statement acknowledges the positive impact deregulation has had on the transport sector. Despite this admission, the government has been unwilling to commit to deregulation of the bus industry. The framework proposes the introduction of a franchising system with both public and private contributions. However, licenses will only be granted to private operators for routes which the state body, Bus Átha Cliath, does not already operate on.

The regulatory decision-making of a minister is carried out with political considerations in mind. Many politically motivated decisions are short sighted and often not the best solution in the long term due to electoral pressures. In the case of the regulation of state owned firms[12], another consideration is the fact that the entity is owned by the state and thus the minister has an interest in the maximisation of its value, resulting in the potential dampening of competitors. Furthermore, government departments may not have adequate expertise to best evaluate regulatory decisions, leaving room for regulatory capture to occur (Gorecki, 2010).

Conclusion

Airline deregulation was considered ground breaking in the 1980s and taxi deregulation was considered a landmark for 'Irish law dealing with property rights and market access' (Barrett, 2003b, p.40). However, many problems still exist within the Irish regulatory framework. Despite the obvious gains from deregulation, as outlined above, there remains a reluctance to embrace open competition. In many cases, this unwillingness can be ascribed to regulatory capture.

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[11] This is due to the nature of political decision-making as outlined above in Stigler's theory.
[12] CIE being one of the largest semi-state bodies in Ireland

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