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Regulatory Competition: A Primer

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Government regulation is often perceived as a good way to address problems that are believed to be caused by market failure. However, regulations can also increase the cost of doing business and make products more expensive for consumers. Over the course of many years, regulations can easily grow beyond their original intent, to the point of creating real economic drag. A solution to this problem, surprisingly, may be more *regulators*. A given government jurisdiction—local, state, or federal—can provide regulatory alternatives to compete with those of another government.[1] Regulatory competition can attract more businesses and jobs, yield regulations that are more efficient and less expensive, and thereby provide more options to consumers.

This paper provides a brief overview of how regulatory competition can provide better outcomes for both businesses and consumers. It also outlines three major kinds of regulatory regimes, and addresses the question of which of these best allows for competition among regulators.

Types of Regulatory Competition. Regulatory competition can occur horizontally—among co-equal governments at various levels—or vertically—for instance, between state and national governments. Governments' motivation for horizontal, and in some cases vertical, competition is to attract new businesses to bolster tax revenue and help spur job growth and economic development. With horizontal competition, companies may move to the jurisdiction that provides the most effective regulation in terms of the firm's business model. When a company does move, it takes its tax revenue and demand for office space and employees with it. Vertical competition, on the other hand, may not necessarily require companies to move to enjoy the benefits of a different regulatory program.

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Types of Regulation. Regulatory structures fall into three distinct categories: loose, strict, and varied.[2] Loose regulations are often cited in discussions on the alleged negative effects of regulatory competition. Former Federal Reserve Board Chairman Arthur Burns (1970-1978) dubbed it "competition in laxity."[3] It is also known as a "race to the bottom," since loose regulations can correlate with lower safety standards and higher accident rates. They also lower initial compliance costs,[4] but those lower initial costs may hide other costs. Externalities such as oil spills or higher taxes for the subsequent government cleanups may increase the cost of loose regulations. On the other hand, loose regulations allow for lower cost production inputs, lower administrative costs—for both firm and regulator—and industry flexibility during economic shocks.

Cooperation between advocacy groups and established companies working together to ensure higher mandatory standards often results in strict regulations. A classic example is the anti-CFC-ozone movement of the late 1980s. After initial resistance to CFC regulation—which would have resulted in elimination of CFCs—established chemical companies found that they could increase entry costs into the industry and reduce competition by encouraging strict regulations. Both parties got what they wanted—environmental groups got lower CFC emissions and the top three companies secured industry dominance.

There are large drawbacks to strict regulations. Final products will be more expensive for consumers because of higher monitoring, enforcement, and administrative costs, and because of producers' reduced ability to lower the costs of production inputs. In addition, strict regulations do not allow for the flexibility that companies may need in a changing market.

Varied regulatory systems are sustainable, though not without conflict. For example, the dolphin-safe tuna episode of the 1980s and 1990s was fraught with problems—including court orders, bans, voluntary export restraints, and asset seizures[5]—that raised consumer prices.[6] One way to avoid fights for regulatory dominance is a mutual recognition agreement (MRA), whereby jurisdictions agree to let in goods produced in, and which conform to, another jurisdiction's regulations. Many examples of MRAs are found in the European Union for such things as alcohol.[7] The United States recognizes MRAs for commercial air travel. Foreign air carriers that follow International Civil Aviation Organization standards may fly into the U.S., while U.S.-regulated carriers are allowed into other countries' airspace on reciprocal terms.

One of the main virtues of varied regulations is greater consumer choice. They let producers to choose the regulatory system that allows them to provide more competitive arrays of products or services to match their customers' preferences. Some may seek to cater to the price-conscious, while those companies that choose to adhere to more strenuous regulations can rely on consumer willingness to pay a premium for an extra moral dimension to a particular product, such as for example, dolphin-safe tuna.

Varied regulatory systems spur regulatory innovation. The desire to attract new businesses will motivate all governments involved to create more efficient regulations. These innovations may include, but not be limited to, administration, enforcement, methods for collecting and analyzing data, and the rulemaking process itself.

Case Study 1: Banking. The banking industry is the best-known example of regulatory competition in the United States. The National Bank Act (NBA) of 1863 gave banks the option for federal chartering, though nationwide banks did not immediately form. During the mid 1970s, states, which had actively discouraged interstate banking, began to look to out-of-state banks as a way to bring in new capital and to make their own banks more competitive.[8] The gradual opening of state financial markets created a labyrinth of state regulations and reciprocity agreements. The Optional Federal Charter (OFC), created by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 and its follow-on acts, offered a way through the maze of state rules by creating a system of optional federal regulation.

The results of the Optional Federal Charter have been generally positive. While bank mergers and consolidations have resulted in layoffs and a reduction in the total number of banks, there has been an increase in the number of bank branches, an expansion of service menus, increased product innovation, improved service delivery, greater regulatory efficiency, and increased bank security and economic stability.[9] (However, the impact on bank profits is less clear, as several studies show mixed results.)[10]

Case Study 2: Pipelines. Another example of regulatory competition is the case *Public Utilities Commission of the State of California v. Federal Energy Regulatory Commission*. During the mid to late 1980s, enhanced oil recovery (EOR) companies, which specialize in increasing the amount of oil extracted from a site, began to enter the southern California energy market with the authorization of the Federal Energy Regulatory Commission (FERC). With FERC approval, EORs bypassed established oil pipelines and initiated several main pipeline projects.

At the time, the California Public Utilities Commission (CPUC) gave residential customers priority over industrial customers. EOR companies, whose customers are mostly industrial, wanted low transport rates, consistent gas service, and a regulator that could guarantee those benefits.[11] For these reasons, and the fact that EORs believed that the FERC would be less likely to change contract terms because decisions could be appealed in federal courts, the EORs opted for FERC regulation.[12]

The CPUC, in response to this perceived encroachment on its CPUC regulatory territory, took the FERC to court. In the end, competition from the FERC compelled the CPUC to improve its own regulatory structure—it acknowledged the need for additional pipelines and reformed transportation rates so that industrial customers could at least pay a premium for reliable transportation.[13] After a series of related judicial decisions, in 2006 the Ninth Circuit Court of Appeals ruled in favor of the CPUC, stating that the FERC "cannot use [its] choice [of regulatory regime] to excuse its duty to maintain effective oversight [of rates]."[14]

Case Study 3: Optional Federal Chartering for Insurers. The National Insurance Act (NIA), currently under consideration by both houses of Congress (H.R.3200, S.40), would create an OFC system for the insurance industry. This would result in a more robust and less expensive insurance industry. Federal chartering would be optional; states would retain full authority over insurers and agents who remain within state systems.[15]

Under the NIA OFC system, states would not be required to change their regulations, and insurance policies from companies that do not opt for federal chartering would not change. States will also retain all business and policy premium taxes within their borders, regardless of where an insurer is chartered.[16]

The NIA OFC would create a competitive regulatory environment between federal and state regulators, which could prompt state regulators to reduce compliance costs by creating a uniform code of regulations and requirements—thereby forming a de facto single alternative to OFC—or by streamlining their existing policies for easier compliance.[17]

The OFC also would benefit insurers by establishing a central federal repository for applications and inquiries. Competition between federal and state regulators would promote innovative and efficient regulation, for state and federally chartered companies alike.[18]

In addition, federal regulations could offer a uniform alternative to confusing state regulations. One study estimates that annual industry-wide savings on regulatory compliance could exceed $600 million.[19] Another study offers a higher estimate, $5 billion (though the authors note that is less than 1 percent of the industry's total premiums).[20]

In addition to money savings from lower regulatory compliance costs, the OFC would directly benefit consumers by allowing them to choose any OFC insurance company in any state. This will be particularly valuable for customers with vacation homes or investment property, military families, and anybody who moves or owns property in multiple states.

Regulatory competition does not necessarily lead to a "race to the bottom" for consumer protection. The NIA would create an Office of National Insurance, complete with a Fraud Division, which would make the sale of fraudulent insurance policies a federal offense for the first time in U.S. history.[21]

The NIA would eliminate government-imposed price caps, which were originally designed to make insurance affordable for high-risk customers. Nearly every state requires state approval or sets a limit on how much insurance companies can charge customers (only Illinois allows the market to set insurance rates[22]). This means that low-risk customers end up subsidizing the extra cost of insuring high-risk customers—even when the high-risk customers are rich or the low-risk customers poor. Another problem is

that some price caps are so low that insurance companies cannot afford to operate in some states. For example, Geico does not sell insurance policies in Massachusetts because that state requires insurance companies to insure any person who requests it.[23]

Conclusion. Regulatory competition can be an important method for reducing regulatory costs imposed on companies, which companies in turn pass on to consumers. Different localities' desires to attract businesses would spur governments to devise regulations that are efficient and find new ways to improve older regulations. Furthermore, a variety of regulatory systems offer companies a choice between regulations.

Of the three different types of regulatory structures—loose, strict, and varied—only varied regulatory systems create sustained regulatory competition. Varied regulatory systems have the potential to create regulations tailored to a specific jurisdiction and lower compliance costs.

Notes

[1] Charles Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy*, 64(5), 416-424, 1956. Only if the company is subject to one set of these regulations at a time.
[2] As defined in Dale D. Murphy, *The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy,* Oxford University Press, Oxford, University, 2004.
[3] Ibid, p. 6.
[4] Shipping companies that use flags of convenience "on average lost three times as many ships annually from 1948 to 1999 as [those using] national registries." Murphy, pp. 53-54. However, using flags of convenience allows these companies to avoid taxes, safety regulations, navigation standards, and crew requirements. Murphy, p. 46.
[5] Murphy, pp. 192-195.
[6] This involved the U.S. and Mexican governments, including the Commerce and State departments, federal, and various U.S. district courts, the U.S. Trade Representative, GATT, Environmental Defense Fund, Earth Island Institute, the Inter-American Tropical Tuna Commission, the U.S. tuna processing industry and Mexican, American, and to a lesser degree Spanish, Venezuelan, Vanuatuan, Panamanian, and Ecuadorian fishing industries.
[7] For example, those enforced after the elimination of Germany's Beer Purity Law which created intra-EU trade barriers.
[8] Peter S. Rose, *Banking Across State Lines: Public and Private Consequences*, Quorum Books, Westport, Connecticut, 1997, pp. 36-37.
[9] Rose, p. 71 and Michale H. Moskow, "Stability in Times of Change," 2006 Annual Report, Federal Reserve of Chicago, http://www.chicagofed.org/about_the_fed/annual_report.cfm, 2.
[10] See Rose, pp. 101-102 for a summary of key findings.
[11] Jerry Ellig, "Why Do Regulators Regulate? The Case of the Southern California Gas Market," *Journal of Regulatory Economics,* 7, 1995, p. 298.
[12] Ibid., p. 301.
[13] Ibid., p. 304. FERC continues to regulate transportation rates for interstate gas pipelines in Southern California.
[14] *Public Utilities Commission of the State of California, et al v. FERC* 474 F.3d 587, http://www.ferc.gov/legal/court-cases/opinions/2006/0374207.pdf.
[15] "Advocacy: Optional Federal Charter," National Association of Insurance and Financial Advisors, p. 1.
[16] For more on this, see CEI's Optional Federal Chartering FAQ, http://www.ofcfaq.org.
[17] For more on competitive regulation, see Christopher Demuth, "Competition in Government," Bradley Lecture, American Enterprise Institute for Public Policy Research, Washington, D.C., October 4, 2004, http://www.aei.org/publications/pubID.21341,filter.all/pub_detail.asp.

[18] There are worries that the federal government will either impose regulations that supersede states' regulatory powers or push state regulators out of the market. States may counter by providing more competitive regulation.

[19] Maria Woehr, "Opting in or Out?" Finance Tech, May 3, 2006, http://www.financetech.com/showArticle.jhtml?articleID=187003162.

[20] Martin F. Grace and Robert W. Klein, " Efficiency Implications of Alternative Regulatory Structures for Insurance," American Enterprise Institute Conference on Optional Federal Chartering and Regulation of Insurance, June 10, 1999, p. 42.

[21] New Hampshire Insurance Department, Outline of National Insurance Act (NIA) of 2006, p. 2.

[22] The American Bankers Insurance Association et al., "State Regulatory Modernization Proposals as Federal Solutions," as sent to Rep. Richard Baker (R-La.), December 12, 2003, http://www.aba.com/NR/rdonlyres/AC523565-294B-4A7E-B8DD-9E8443D58F55/33900/OFCJointTradesResponsetoRepBakerDec122003.pdf

[23] Bruce Mohl, "Mass. still a no-go for Geico," *The Boston Globe*, August 17, 2004, http://www.boston.com/business/articles/2004/08/17/mass_still_a_no_go_for_geic/.