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Measuring the costs and benefits of regulation: Conceptual issues in securities markets

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Abstract

This paper reviews the economic theory of regulation and surveys the empirical evidence on its application to past and recent changes in U.S. securities regulation. The theory provides multiple potential motives for regulation and cautions the empirical researcher against naïve modeling of the costs and benefits of regulatory change. Moreover, the nature of the regulatory process compounds the standard pitfalls of empirical analysis such as endogeneity and confounding events. Productive empirical techniques include the development of cross-sectional predictions of the effects of regulation as well as the use of unregulated control samples. An important avenue for future research is a more refined estimation of the extent to which regulation has unintended consequences.

JEL classification: G14; G28; G38; K22
Keywords: Regulation; Public interest; Special interest; Unintended consequences

1. Introduction

Measuring the costs and benefits of regulation is an important but challenging task for economic analysis. A critical conceptual issue is that there are several economic theories of regulation – ranging from public interest to special interest – that influence the structure of hypotheses and the interpretation of results. Empirical analysis is further affected by the nature of regulatory events which typically react to economic conditions and are drawn out over extended

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periods of time. These aspects of regulatory events compound the standard pitfalls of empirical analysis such as endogeneity, confounding events, specification sensitivity, and statistical power.

In this paper, I review the body of theory and evidence on the economic study of regulation. My goal is to draw on the extant literature to better shape the future estimation of the costs and benefits of regulation. My emphasis will be on the regulation related to the U.S. Securities and Exchange Commission (SEC). In addition to being consonant with the theme of this edition of the Journal of Corporate Finance, there are particular reasons to devote attention to the SEC. Contrary to world trends in privatization and deregulation (Shleifer, 1998), the powers of the SEC appear to be expanding. For example, the Sarbanes–Oxley Act moved the SEC beyond the simple provision of disclosure to the more active mandate of actual corporate policy (Romano, 2005).

In juxtaposition to this expansion of the scope of the SEC, however, the courts continue to monitor the decisions made by the agency. For example, recent decisions by the U.S. Court of Appeals have tempered the SEC's efforts to impose broader governance requirements on the mutual fund industry. Justice Ginsburg remanded the rulemaking back to the SEC for "failing adequately to consider the costs mutual funds would incur in order to comply with the conditions and by failing adequately to consider a proposed alternative" (Chamber of Commerce v. SEC, 366 U.S. App. DC 351 (June 21, 2005)). The tone of this ruling remarkably resembles the admonition of SEC policymaking by George Stigler (1964a, pp. 117–118) more than 40 years ago, where he posed an essential research question: "how does the [SEC] show that the changes it recommends (a) will improve the situation, and (b) are better in some sense than alternative proposals?"

Following Stigler's (1964a) call for research, a substantial literature has arisen on the economics of regulation, including a large body of analysis of the SEC. Section 2 reviews the central conceptual and measurement issues that have been raised by the regulation literature. Section 3 then frames the various ways to model the specific regulation of the SEC. Section 4 surveys the historical studies of the costs and benefits of SEC regulation and Section 5 considers some of the ongoing research on the current regulatory efforts of the SEC. Section 6 provides a summary and conclusion.

2. Conceptual and measurement issues in the study of regulation

2.1. The underlying theory and testable hypotheses

George Stigler was the original advocate for the systematic study of the costs and benefits of regulation. He called for the development of testable hypotheses on regulatory policies followed by scientific analysis of pertinent data. See, for example, Stigler (1964a,b, 1971, 1972, 1974) and Stigler and Friedland (1962).

To develop testable hypotheses, one must have a model of regulation. Economists have developed at least two distinct regulatory models, which can be labeled the public interest theory and the special interest theory. The public interest theory is the traditional statement that regulation responds to market failure as an attempt to improve social welfare (for a critique, see Chapter 25 of Alchian and Allen (1964)).

The special interest theory, by contrast, argues that regulation responds to various political support groups. The motivation for this alternative depiction of regulation was the observation that many regulations appear aimed not at consumer protection but instead at producer protection (Stigler, 1971). Moreover, regulations also often appear to have differential effects on small versus large firms in an industry (Stigler, 1974). The basic economic theory of regulation was extended from a simple capture hypothesis to a broader special interest hypothesis by Posner (1971, 1974)