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Transaction cost regulation☆

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ABSTRACT

This paper discusses the fundamental underpinnings and some implications of transaction cost regulation (TCR), a framework to analyze the interaction between governments and investors fundamentally, but not exclusively, in utility industries. TCR sees regulation as the governance structure of these interactions, and thus, as in standard transaction cost economics, it places emphasis in understanding the nature of the hazards inherent to these interactions. The emphasis on transactional hazards requires a microanalytical perspective, where performance assessment is undertaken within the realm of possible institutional alternative. In that sense, politics becomes fundamental to understanding regulation as the governance of public/private interactions. The paper discusses two fundamental hazards and their organizational implications: governmental and third party opportunism. Both interact to make regulatory processes and outcomes more rigid, formalistic, and prone to conflict than envisioned by relational contracting.

1. Introduction

Transaction cost regulation (TCR) consists of the study of the governance features of the interaction between governments and investors fundamentally,[1] but not exclusively, in utilities sectors. As in standard transaction cost economics, the nature of contracting hazards is what determines the fundamental features of the governance of these interactions (e.g., Williamson, 1979). Regulation, and regulatory contracts, the forms that take the governance of such interactions, are then to be understood as coming to grips with the inherent hazards of these interactions.

Emphasizing regulation as the governance structure of these interactions, and understanding the organizational impact of their inherent contractual hazards, differentiates TCR from other approaches to regulation. In particular, the emphasis on contractual hazards requires assessing real behavior, by real people in real environments within real institutions.[2] While understanding real behavior also implies analyzing rent seeking and the role of distributional concerns, these manifest themselves in the interaction of sector hazards with the institutional environment within which they operate. In that sense,

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[1] Observe that I did not say "transaction" but rather interaction, as a transaction only occurs if a regulatory action actually takes place, which, TCE would naturally require to be an endogenous result of the government/investor interaction.

[2] As a consequence, TCR rejects the notion of "optimal" regulation.

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although politics is normally not necessary to understand private contracting, it becomes fundamental to understanding regulation as the governance of public/private interactions.[3] As emphasized first by Coase (1964) and subsequently by Williamson (1979), the analysis of regulation must be done within the proper institutional comparison, and with a heavy micro-analytic dose. Thus, the supposed inefficiency of regulatory contracts, and of regulatory outcomes, must be assessed in reference to all relevant alternatives.[4]

It is worth discussing, at the outset, the differences between TCR and two alternative theories of regulation: The Chicago School and Incentive Theory. TCR differs from the Chicago School, as exemplified in the path breaking work by Stigler (1971), Peltzman (1976) and Posner (1971), in that, although rent seeking and distributional effects are important to understand regulatory outcomes, TCR emphasizes the interaction between the particular hazards associated with the sector and the institutional environment in which the sector operates. The solution to the associated hazards, then, will impact on the nature of regulatory institutions, how regulation operates, and on sector performance. In other words, TCR calls for the opening of the black box of regulation. TCR also differs from the incentives theory of regulation, as developed following the path breaking work of, among others, Loeb and Magat (1979), Baron and Myerson (1982), and Laffont and Tirole,[5] in two main respects. First, TCR emphasizes that the contracting schemes that are required to provide second best incentives are dependent on the institutional environment in which the firms operate. By developing the link between the institutional environment and the type of regulatory institutions that are feasible, we can, implicitly, develop the institutional conditions under which incentive regulation becomes feasible. Second, since the incentive theory of regulation shares the "black box" approach to politics of the Chicago School,[6] the emphasis on institutional determinants rather than pure efficiency incentives separates TCR also from the incentive theory of regulation.

In this paper, then, I develop the fundamental features of this approach, and present fundamental implications that differentiate TCR from alternative approaches to regulation.

2. Williamson's incipient TCR

In his path-breaking 1976 BJE,[7] Williamson sketched the fundamental tenets of a TCR approach.[8] Williamson (1976) analyzes in detail the alleged advantages of franchise bidding in CATV service regulation, by emphasizing the contractual details involved in undertaking a franchise bidding against a more standard (rate of return) regulatory process. He starts, following Coase (1964), by emphasizing the need to perform real institutional comparisons:

> Merely to show that regulation is flawed, however, does not establish that regulation is an inferior mode of organizing economic activity. . . Secondly, before regulation is supplanted, there is an obligation to assess the properties of the proposed alternative – not only in general, but also specifically with respect to the activity in question. If the proposed mode is flawed in similar or different respects, the purported advantages of shifting out of regulation may be illusory.[9]

Using the incipient TCE approach, Williamson (1976, p. 75) then highlights seven features relevant to evaluating alternative modes of organizing natural monopoly supply (with emphasis on comparing franchise bidding to other forms of regulation – including no regulation):

> (1) the costs of ascertaining and aggregating consumer preferences through direct solicitation; (2) the efficacy of scalar bidding; (3) the degree to which technology is well developed; (4) demand uncertainty; (5) the degree to which incumbent suppliers acquire idiosyncratic skills; (6) the extent to which specialized, long-lived equipment is involved; and (7) the susceptibility of the political process to opportunistic representations and the differential proclivity, among modes, to make them.

We can reclassify these seven considerations into four that are basically transaction cost considerations (items 3- technology, 4- demand uncertainty, 5 and 6- specific investments /skills) and three that arise from political considerations (1 – preference aggregation, 2 – efficacy of scalar bidding and 7- political opportunism). Williamson (1976), then, set out the two fundamental pillars of TCR – transaction costs economics, and positive political theory. TCE's emphasis on identifying the transaction hazards as the basis for understanding governance, and the consequent discriminating alignment of governance and underlying risks; and positive political theory, which by highlighting the political dynamics associated to these interactions, helps to elucidate the full extent of the hazards associated with these interactions.[10]

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[3] For an institutional theory of public contracts, see Spiller (2009).
[4] See also Williamson (1996).
[5] See the summary of their work in Laffont and Tirole (1993).
[6] Observe that in most of the incentive theory of regulation literature, the regulatory process is described by a regulator's utility function. Interesting extensions into hierarchical or more dynamic models of regulation have brought some institutional flavors to this literature. See, for example, Demski and Sappington (1987), Baron and Besanko (1987), and Laffont and Tirole (1993).
[7] See, Williamson (1976).
[8] A parallel, although different, application of TCE to regulation can be found in Goldberg (1976). For an application to comparative regulatory governance, see Spiller (1993), later developed in Levy and Spiller (1994).
[9] See, Williamson (1976, p. 73).
[10] For a recent survey of the implications of positive political theory to regulation, see Spiller and Tommasi (2008).