Regulation by Independent Agencies: Who is the Principal, and What Does She Want – With Examples, mainly from Transport Regulation in Italy

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Abstract

At the center of regulation, as performed by independent agencies, there are two primary principal-agent relationships: downstream, regulatory agencies act as principals vis-à-vis regulated firms; upstream, regulatory agencies themselves act as the agents of government (parliament and/or the executive). This paper looks at the second relationship, which is, of the two, both the more important (because of its position at the top of the decision-making chain) and the less structured (as governments usually do not have direct power, or control, over the agencies – hence the characterization of these as "independent"). In addition, this relationship is further complicated (and muddled) by the presence of a number of influential actors, consumers, firms, experts, the media and the courts. The paper focuses on the complexity of economic and political interests in this relationship to discuss how it affects regulation by independent agencies. The exposition will draw from the available theories of regulation (incentive, or contract, or public choice-based), and considers examples, mainly from transport regulation in Italy. This regulation has evolved considerably over time, and the shapes that it has taken offer evidence of different possibilities as to the operation of the principal-agent relationship, as well as the following regulatory outcomes.

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Introduction

Independent regulatory agencies (IRAs) are a subset of the independent agencies which, in many countries, are entrusted with supervisory tasks with respect to economic sectors (from banks to utilities to finance to the media) or economy-wide issues (from antitrust to consumer protection to data protection).

In this paper, Italian IRAs are looked at from the point of view of their governance structure. On the one hand, IRAs perform similar tasks (in the main, price and quality regulation), and share similar organizational features; thus they lend themselves straightforwardly to joint analysis. On the other hand, while many issues considered in the paper for their relevance for IRAs are also relevant for other independent agencies, there are also issues that are specific to individual agencies (for example, central banks, which look very much like independent agencies because of their independence and powers, are characterised, internationally, by a variety of governance structures).

Two main questions – why are they established, how are they managed subsequently – are considered in the two parts of the following exposition. A concluding comment on policy implications is added.

I - IRAs, why they do exist, and what they are for

Normative economics gives a straightforward interpretation of why IRAs exist, and what are for. There are industries and markets where consumers interests are at disadvantage *vis-à-vis* business interests, because of market failures – natural monopoly (arising from the existence of large infrastructures), and, possibly, asymmetric information. The correction of these market failures calls in public policy intervention: this can be in the form of direct government intervention, through government departments; but this is hardly advisable, as governments are too exposed to the whims of the electorate, the pressures of interest groups, and the self-dealing tendencies of politicians and public bureaucrats. Thus, the preferable form of public intervention is through specialised, highly competent, and independent agencies.

But while this suggests a (normative) rationale for intervention by independent agencies, clearly its value in a positive perspective is an open question. Missing a benevolent social planner (a benevolent dictator), it cannot be expected that the prescriptions of normative economics are systematically translated into actual policy measures, as these are determined by political processes, and these, in turn, by the actions and interactions of many agents (agents whose influence can also vary, considerably, over time).

In the case of regulation by independent agencies there is, indeed, a puzzle. Politicians are usually jealous of their powers (a jealousy which is perhaps, at least in Italy, a

constituent element of the oft-voiced principle of the primacy of politics); why then do they give up a not negligible portion of them, by transferring it to IRAs?

At the same time, in the case of IRAs, it cannot be overlooked that they bear remarkable resemblance to the agencies envisioned by the prescriptions of normative economics.

(1) - Normative considerations can have an impact on political processes, especially in some circumstances, when a feature, or features, of the workings of the economy are newly discovered as defective and/or worrisome, and therefore in need of remedial policy. In such non-routine circumstances, the experts and the media focus their attention analyses on the relevant issues; public opinion is informed and to some extent mobilized; finally, politicians and public bureaucrats are induced to listen to, and take part in the debate – perhaps also to take consequent policy initiatives.

In the case of IRAs, the occurrence of such circumstance can be located in the mid-eighties, when in the United Kingdom the privatization process took off, and an intense debate about the need of accompanying measures was started. The nationalisations of the late forties and early fifties, which had brought many companies into public ownership, had been justified in relation to the pursuit of public interest; and it was felt that in the case of utilities, a public interest, namely the protection of consumers from monopoly, was to be pursued also after privatisation. Attention was thus directed to government agencies which in the United States had performed, reasonably well, regulatory tasks with respect to utilities, since a long time (notably the Ferc-Federal Energy Regulatory Commission, from 1920; the Fcc-Federal Communications Commission, from 1934; the PRC-Postal Rate Commission, now Postal Regulatory Commission, from 1970)

The formula of the American regulatory commissions was imported into the UK, and several independent (non-ministerial) agencies were established: Ofwat-Office of Water Services, in 1984; Ofgas-Office of Gas Supply, in 1986; Offer-Office of Electricity Regulation, in 1990; and, much later, ORR-Office of Rail Regulation, in 2004 (subsequently, this organizational structure was revised, and now the independent agencies are Ofwat-Water Services Regulation Authority; Ofgem-Office of Gas and Electricity Markets; and Orr-Office of Rail and Roads).

Many other countries have followed this path, and in Europe the principle of regulation by independent agencies has found an endorsement in the EU sectoral liberalisation packages.

In the end, in a relatively short span of time, an American invention, through a British reinterpretation, has become, internationally, a customary arrangement.

(2) - In the previous account, the establishment od IRAs has been seen, in essence, as a consequence of intellectual debate – not of the interplay of interest groups and political institutions.

But what, then, the role, and stance, of interest groups and political institutions? In the discussion around the establishment of IRAs, a conjecture is sometimes advanced, that IRAs might be in the interest of regulated companies, as they would offer protection against government opportunism – i.e. the possibility that governments, to accommodate popular pressures, enforce price controls and keep prices – and thus profits – below sustainable levels.

This may well happen, and it has happened in the past. But it cannot be seen as a regular occurrence, as it was typically resorted to in periods of high inflation (as an anti-inflation measure), and during economic crises (as an anti-poverty measure). Furthermore, regulated companies are used to deal with governments, and can be expected to have in place communication channels – and also lobbying relationships; independent agencies, in turn, can act as strict regulators. For companies, regulatory risk, when arising from government regulatory power, does not seem to be greater than regulatory risk arising from IRAs.

As for political institutions, it is similarly difficult to find a motivation for the delegation of powers to IRAs. As noted above, IRAs entail an erosion of politic-bureaucratic power, and seem to offer little or nothing in exchange. A suggestion that can be found in the literature is that IRAs can offer specialized knowledge; but, then, specialized knowledge can well be present in, or obtained by governments.

Our conclusion, on this point, is that the establishment of IRAs was accepted, or, perhaps, endured, by interest groups and political institutions, which indeed hold no identifiable interest in that establishment.

(3) - The previous account of the circumstances leading to the establishment of IRAs is also broadly in agreement with the Italian experience. The two main Italian IRAs where established in 1995, at the height of the privatization cycle (law 29 Sept. 1991, no. 48; the two IRAs were Aeeg, with oversight of the energy industries, and Agcom, with oversight of the communication industries). The same law (article 2, section 4) stated also that other utility sectors would be dealt with by future legislation.

However, as privatization become gradually routine policy, the statement was entirely forgotten, until much later, when, due to growing EU pressure, the transport regulator (Art) was established in 2011, and the postal regulator in 2012 (as a section of Agcom, see the last paragraph above).

There are no indications that this 15 years delay was resented by the utility companies, or by the public bureaucracy. In at least two particular cases, the regulation of motorways and airports, the companies and the government bodies in charge of regulation (two government-controlled agencies, Anas and Enac, the first later replaced by a government directorate) agreed on and signed several contracts involving price and quality commitment on the part of the regulated companies.

(4) - A corollary of this line of reasoning is that first generation agencies (those established on the occasion of privatization), benefiting from a favourable climate, are likely to be more robust; while second generation agencies (established later on) are likely to be weaker; also, over time, the first ones are likely to weaken.[1]

(5) – A second corollary can then be that first generation agencies, over time, and second generation ones, since they are established, may be liable to capture by companies (a widely studied phenomenon – and one which appears to happen often). However, governments and politicians, at the same time, maintain an influence, and thus, depending on the prevailing stances, can deter or favour capture.

II - A multifaceted, fluid principal

Principal-agent theory can offer a first guide to the understanding of the situation sketched above.

The previous considerations can be interpreted according to principal-agent theory, given that IRAs act as the agents of parliament and/or executive. The principal-agent (PA) framework originated in economic theory to describe contract-based interactions between a principal and an agent, who acts on the principal's behalf. This framework has become inescapable when studying delegation relations and, in particular, the interactions between elected politicians and public officials (Maggetti and Papadopoulos, 2018). Moreover, in the case of regulatory agencies, the agency problem is more complex than inducing the agent to act in the political principal's interests, as the structure of delegation should ensure, here, that the regulators are unresponsive to those interests (upstream), as well as insulated from pressures by the regulated firms (downstream).

Although the PA framework is a useful guide in the study of the relationship between regulators and government, we argue that it is more complicated, muddled and nuanced than suggested by the traditional view of the role of IRAs in the regulatory state. This is the case, especially, of those (normative) theories that, on the one hand, argue that the key functional rational - for delegation to an IRA - is securing credible commitments to market players and other stakeholders (to guarantee that the rules of the game do not change over time); or that, on the other hand, assume regulators are in a better position (than their principal) to improve social welfare, by limiting the industry's ability to exploit their sources of market power.

In the case of IRAs, the agency problem is, in fact, more complex than inducing the agent to act in the principal's interests: on the one hand, the structure of delegation to IRAs should ensure, normatively, that regulators are unresponsive to those interests

[1] See, e,g., Martimort (1999), and the references to previous literature therein.

(upstream), as well as insulated from pressures by the regulated firms (downstream); on the other hand, the political principal is a multiple, changing one (who, as noted above, is exposed to the whims of the electorate, the pressures of interest groups, etc.). Indeed, it is widely acknowledged that regulation involves government intervention in markets in response to some combination of normative objectives and private interests reflected through politics, and that, therefore, the objective of the regulator is generally not unambiguous, for it depends on a variety of normative and positive factors (Baron, 1989). However, from a positive perspective, the traditional view that regulation may be a response to competing interests of consumers and firms, as intermediated by a legislature, seems to pay too little attention to features of principal's identity, that affect her relationship with IRAs from their establishment onwards (Besley, 2006).

Besley and Coate (2003) show that there is a sort of regulatory capture that emerges endogenously through the electoral process, because of diffuse costs and concentrated benefits. Indeed, the differences between the pricing policies of states that appoint or elect their regulators have been the focus of a considerable body of work. "Because voters have only one vote to cast and regulatory issues are not salient for most voters, bundling [of various issues in the electoral competition] provides parties with electoral incentives to respond to stakeholders in the regulated industry" (Besley and Coate, 2003, p. 1177). On the other hand, if regulators are elected, their stance on regulation is the only salient issue, so that the electoral incentive is to run a pro-consumer candidate. Therefore, Besley and Coate (2003) demonstrate that appointment of regulators by elected politicians, rather than direct election of regulators, leads to less consumer-oriented regulatory policies.

Nevertheless, there is yet another relevant characteristic of the regulatory state that needs consideration with regard to the political principal's stance and behavior, namely, "the essential *plurality* of regulation, with the variety of its forms and venues, and the actors which shape regulatory decisions and are affected by them" (Lodge and Stirton, 2010, p. 350). This plurality of regulation, i.e., the complexity of economic and political interests in those relationships, affects regulation by IRAs. In fact, this leads to a much-expanded set of answers to *who*, *to whom*, and *for what*, questions.

Actually, decentered approaches to regulation have long recognized the polycentric nature of agency relations. However, use of the PA framework, to study delegation to IRAs by their political principal, still fails to take a closer look at much of the interactions among actors, that have an influence on the principal, and occur at the top of the regulatory hierarchy, where actors' relations and interests are in a state of continued tension and fluidity (Lodge and Stirton, 2010).

Besides the political principal, there are indeed a variety of influential actors, co-regulators,[2] consumers, firms, experts, the media and the courts, that interact with IRAs. To make sense of this plurality, or, multidimensionality, the concept of regulatory space has been used. Maggetti and Papadopoulos (2018, p. 176) contend that "[r]egulatory spaces are occupied by participants in the regulatory process who are involved in cooperation as well as bargaining and power struggles in regulation, configuring a variety of regulatory regimes … in a way that depends on institutional design and sector-specific actor constellations". Thus, especially in the post-delegation period, interactions between an IRA, her political principal, and other actors and institutions spill over different levels, and evolve over time. For instance, Martimort (1999) analyzes the dynamics of regulation and suggests that regulatory capture comes from the repeated interaction between an interest group and a regulatory agency. Regulatory institutions can put constraints (i.e., rules) on the interest group's influence, and respond to its tendency to exert increasing influence by limiting, accordingly, the agency's discretion.

There is, however, another aspect that, in a PA framework, can add further complexity to the relationship between the political principal, independent agencies, and actors that are in a position to influence regulators' behavior, either directly or indirectly through the political principal. As recently pointed out in Sobol (2015, p. 347), scholars still assume, a priori, that in a PA relationship, the agent is the opportunistic and disloyal actor. Against this background, the author seeks to demonstrate how principals could be as much problematic as their agents. Therefore, "pathological delegation" is defined "as a situation when the structure of delegation itself and features of the PA contract provide perverse incentives for *the principals* to behave in ways inimical to the delegation act and thus hinder the agent's work" (Sobol, 2015, p. 347). Although pathological delegation seems to deserve more analytical work, two key drivers for it are identified, namely, the structure of the delegation act, and the PA contract. The first driver can result in pathological delegation because of a collective principal, with further complications due to preference heterogeneity, or power asymmetries that can be characteristics of the collective principal; the second driver regards the definition of objectives (e.g., conflicting or unclear objectives), or distribution of resources (e.g., insufficient funding) as specific features of the PA contract.

[2] This paper does not consider an IRA's principal as in common agency, which "is the name given to a multilateral relationship where several principals simultaneously try to influence the actions of an agent. Such situations occur very frequently, particularly in the political processes that generate economic policy" (Dixit et al., 1997, p. 752-3; see also Martimort and Stole, 2009).

A concluding comment on policy implications

A conclusion stemming from the previous discussion is that normative economics' prescription, that IRAs should act in the public interest, by keeping under check prices and quality of services rendered by private (monopolistic) utilities, is exposed to the risk of being distorted by the interplay of private interests and public institutions.

There are, however, measures that can help to contain such risk; in the first place, those about appointment of IRA's board members.

(1) - Appointment of board members by the executive should be preferred to appointment by parliament. This alternative finds considerable attention in the Italian discussion;[3] here it will suffice to say that it gives greater visibility to the responsibility for such appointment – and thus it is to be expected that politicians are to some extent constrained by being observed by the media and public opinion.

(2) - The carve up of the appointment of board members among parties, belonging to the majority as well as to the minority, should be phased out.

(3) Board members are now appointed for seven-year terms, and in case of death or of resignation of board members, the new appointments are made for the residual period; this should be changed, and new appointments made for seven year, as this would confer some continuity to IRAs behaviors.

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[3] See, e.g., Sanino (2015).

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