

## **How Should the Economy be Regulated?**

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When thinking about how the economy should be regulated we need to make a totally fresh start. This is because very little creative thinking about this critical subject has occurred for several decades. Specifically, the current economic crisis is a stark reminder of how outmoded regulatory structures are in relation to the current structure and function of the financial industry, though problems of the financial industry are not the sole or even main cause of the broader economic crisis. But even in the absence of a crisis, rethinking the fundamentals of economic regulation would be long overdue.

Patching a generally broken regulatory system is not enough in the U.S., or internationally. We need new principles on which to base a new approach to regulation, principles that help guide corporate investment decision-making and business management toward practices and outcomes that are much better aligned with the great social and environmental challenges that lie ahead. Fortunately, the six principles that the Corporation 20/20 project has already developed for corporate design are also highly relevant to thinking about new regulatory designs and processes.<sup>1</sup> As these principles make clear, the world's critical social, economic, and ideological challenges, often lumped under the rubric of how to achieve "sustainable development," demand the more targeted and directed use of new capital investment. Unfortunately, the world cannot rely on traditional capital markets alone to properly prioritize the future need for capital among key industries. If we could continue to rely on capital markets to properly allocate capital investment, we would not be facing the multiple crises that are now upon us. At the very least, we need a strong form of "managed capitalism" to guide corporate bodies toward socially-beneficial decision-making.

Regulating the "economy" means regulating all economic sectors of society broadly speaking, not just the financial sector which is most in the public eye today. This means inclusion of almost all areas of society where money or services change hands, including, in theory, the government itself. Listing some of the obvious institutional forms comprising the economy, we have: for-profit public corporations, for-profit private corporations, non-profit institutions of many stripes such as hospitals and universities, small businesses with a single owner, worker-owned corporations, and cooperative societies. The economic sectors that require varying degrees of regulation include: retail, wholesale, financial services, manufacturing, mining, farming, education, health care, and housing, among other sectors.

Given all the permutations and combinations of these types of corporate entities, and these sectors of the economy, we have a very wide range of situations that need to be regulated in

order to advance broad social goals. For each combination of corporate form and economic sector, one key question is how much and what kind of regulation is needed, and who should regulate?

### **Actors and Agents**

In beginning to think about how to regulate the economy, first consider all relevant relationships between the “big three”: businesses/non-profits, government, and civil society. In particular, the proper role that civil society should play in regulation has generally been neglected, in part because even most proponents of strong regulatory processes have not recognized the important pro-democratic benefits that can flow from the more active involvement of civil society in regulatory processes. Since the economy, in the broad sense, comprises many different kinds of institutions, many of which are only partially participants in markets, the appropriate mode of regulation needs to be very different from industry to industry, and from type of market to type of market. In addition, “regulation” does not necessarily just mean regulation by government agencies, even though most regulation probably should be overseen, in a legal sense, by a government or quasi-government agency or commission. And, of course, government functions themselves can be divided into executive, legislative, and judiciary branches, which further complicates the picture.

In addition, there are external factors that affect the optimal regulation of various sectors of the economy. For example, corporations that have a major social and/or environmental impact clearly need more regulation than small businesses that have much less impact. The potential for systemic impacts and risks should also be a justification for more strict and comprehensive regulation. Thus, financial institutions have to be regulated in ways that the manufacturers of common household items do not. After all, the bankruptcy of even a major manufacturer of dishes, for example, would have little systemic impact on the economy. Furthermore, issues of potential market power (quasi-monopoly) also have to be taken into account when assessing the appropriate level of regulation. Then, again, there is a wide variety of labor, wage and salary, pension, health insurance, and health and safety issues to take into account. In short, the picture that emerges is clear—no one size or type of regulatory approach fits all sectors of the economy.

### **Why Regulate?**

In a capitalist market economy, what is the core rationale for regulation? To begin, sound regulation should attempt to prevent a wide range of problems from occurring, including, and this is new, the misallocation of financial resources. Obviously, more regulation of new financial products over the last 20 years might have prevented some or most of the serious damage to corporations and investors linked to the current financial crisis. More broadly, new forms of regulation are needed to help ensure that necessary principles of corporate design such as the Corporation 20/20 principles are, in fact, followed. These principles require that private interests serve the public interest, and that as part of serving the public interest all stakeholders should receive a fair share of all the wealth that corporations create. (See Corporation 20/20 principles #1 and #2 at [www.corporation2020.org](http://www.corporation2020.org).) Thus, achieving the public interest in all its aspects must always be the core rationale of regulation.

The second important relationship between regulation and money arises when investment decision of all sorts are made. The need for regulatory mechanisms to foster more democratic control over a broad range of investment decisions, even those of private for-profit corporations, is greatly under-appreciated. Without greater democratic control over the full range of relevant investment decisions, the public interest cannot be achieved. The majority of the investments that society makes cannot be allowed to be controlled solely by private interests. To do so would most likely mean that neither corporations, nor thereby society, would function sustainably, nor would the wealth and other benefits generated by new investments be equitably distributed. (See, especially, Corporation 20/20 principles #3, #4, and #5 in this regard at [www.corporation2020.org](http://www.corporation2020.org).)

Another type of problem which regulation addresses is the problem of the exercise of market power in various types of markets. If markets are not reasonably competitive, then either temporary or permanent regulation of those markets is justified to ensure enhancement of the public interest by achieving the fair pricing of products and services in those markets. Fair pricing also would help ensure that Corporation 20/20 principles #2 and #4 were implemented; namely, that the wealth and value generated by business would be distributed fairly among relevant stakeholders, especially consumers in this case.

Regulation can, then, have a profound effect on how society spends or invests its financial resources, and what it pays for its products and services. Markets do not necessarily yield optimal, aggregate investment patterns owing to information shortcomings, their failure to account for externalities and multiple social goals, and a lack of ethical considerations which would help direct the flow of capital to socially desirable ends.

Finally, as noted previously, regulation can and should be an instrument to ensure more democratic decision-making. This occurs, both by allowing greater [public](#) review of decisions and issues being regulated, by facilitating greater transparency and public disclosure of the information on which decisions being regulated are made, and by providing a platform for a wider range of stakeholder input into, and power over, relevant regulatory decisions, including investment decisions. (See Corporation 20/20 principle #6 which supports the right of natural persons to govern themselves, which should include their right to democratically decide how society's financial resources should be invested to achieve social goals.)

In contrast to these reasons for regulating institutions, markets, services, and products, there are common arguments against doing so. One main claim is that regulation is not economically efficient in many situations. Implicit in this claim, of course, is the view that economic efficiency is the most important factor to take into account when considering how to regulate the economy. In fact, economic efficiency is but one criterion by which to judge the performance of an economy and a society. The degree of democratic decision-making is another, perhaps more important criterion. And, no one approach to making investment decisions is going to lead to perfect outcomes, since no approach can achieve perfect foresight. Thus, having more democratic input to decision-making should help blunt criticism when some investments, in fact, turn out to be underperformers, as is inevitable under any set of regulatory or market structures.

A second argument against regulation is that it is often too expensive relative to its potential benefits. This argument is clearly related to the economic efficiency argument above, because doing a cost/benefit analysis of regulation is part of measuring economic efficiency. Of course, this argument is often disingenuous because the risks of proceeding with unregulated processes are usually not fully (or even partially) accounted for in such a cost/benefit analysis. Partly this happens because the analysts artificially segregate what they call public and private costs, as if private financial losses are not social costs as well, and vice versa.

Finally, some attack regulation on the grounds that it reduces the freedom of certain economic actors, such as business owners, to act in ways that they claim as an entitlement. The presumption behind this argument seems to be that people have certain “rights” to carry out their business without regard to their impacts, as if such activities exist in outer space. This argument tends to ignore the fact that without the existence of many social institutions—not the least of which are the courts, regulatory agencies, and the rule of law—doing business would be impossible. Of course, pro-business ideology tends to strongly emphasize the need for the rule of law to protect their property, but it is less enthusiastic about relying on the rule of law to protect the rest of society from the negative consequences of business enterprises themselves.

### **Better Regulatory Processes**

What new regulatory institutions and processes should be created to advance the public interest while enabling responsible enterprises to prosper? One group that should be considered for a much more active role in future regulatory bodies is civil society, defined as all those organizations consisting of voluntary groups of citizens that form around a set of issues. Usually, these organizations are non-profits. They could be faith-based, unions, environmental groups, or PTAs, among others.

We also need to remind ourselves that regulation often works by regulating the activities of people, in addition to the institutions for which they work. This is often the case for workers whom we consider “professionals.” Various types of professionals are often regulated by licensing standards aimed at strengthening the quality and safety of the services they provide. This approach to regulation applies to both doctors and public accountants, among many others. Probably other professionals should be more highly regulated as well, such as financial sector workers of various types. Of course, just because accountants must be licensed as individuals, does not mean that accounting firms that consist of many licensed accountants should also not have their operations regulated. But clearly there is an efficiency-related trade-off illustrated by this example between the efficacy of regulating individual employees, and the regulation of the institutions in which they work.

### **The Public Utility Commission Model**

At least one somewhat obscure but potentially powerful model exists for a regulatory process that could regulate much of the economy in which medium-size and large corporations are the main actors. This is the American model of public utility commissions (PUCs). PUCs are best known for rate-setting with respect to energy, telecommunications and water. But even more important is their little-known role in approving all major utility *investments*, and all utility

*products* for which they set rates. It is the fact that PUCs have the authority to approve investments that makes PUCs particularly powerful. They are given this authority to approve investments because a large part of the cost of all utility services provided to the public is the cost of paying off capital investments in plant and equipment.

In addition, the kind of investments approved by PUCs often determines many of the other costs of providing services to customers over a very long time period for any given type of utility service. For example, if a PUC approves a major investment in a new coal-fired electric power plant instead of in a new natural-gas-fired power plant, doing so commits the electric ratepayers to paying for coal, and not natural gas as the fuel, for the entire life of the power plant, which could be 50 years or more. This decision obviously has many environmental and economic impacts over the long term.

One of the most attractive features of well-functioning state PUCs (there is no exact federal counterpart) is that all decisions are based on evidence, as best the commissioners that serve on these commissions can determine the evidence. Evidence is gathered on all issues that the PUC is obligated to decide by holding formal hearings that must comply with administrative legal processes. Because administrative law is followed throughout the PUC hearing process, the decisions of PUCs can also be appealed to relevant courts. The evidence is supplied to PUC commissioners by witnesses who testify under oath in the hearings. The witnesses in a case are often experts in technical fields relevant to the issues being considered, but non-experts are often allowed to testify as well in order to get a broader range of public input into all decisions, many of which are basic policy decisions. Importantly, all witnesses can be cross-examined by the lawyers of the legal parties to the case to try to further determine the weight that should be given to their testimony, just as occurs in most courts.

In PUC proceedings, all parties to each case are allowed to ask formal discovery questions (make information requests) of the business being regulated, so that reliable and complete information can be relied on by each party to the case. Because of the discovery process, the information advantage that unregulated corporations usually have relative to the general public when it tries to comprehend corporate decisions is greatly reduced.

Importantly, a wide range of types of organizations, corporate, governmental or civil society, can be legal parties in PUC cases. Thus, widely diverse opinions and positions are represented, and usually supported by legal counsel. Sometimes the PUC orders the regulated company in a case to pay for the legal and expert witness costs of representation for stakeholders who do not have sufficient income to pay these costs themselves. This element of the PUC process ensures the fair and relatively equal representation of all stakeholders. Finally, the PUC commissioners and staff members themselves should be chosen from a diverse set of stakeholders, so that democratic decision-making could be even further enhanced.

One implication of applying this PUC model to non-utilities is that regulatory decision-making processes would become far more transparent and publically accessible than is typically the case. For example, currently, many federal regulatory bodies merely allow comments on proposed rules to be submitted, but open public evidentiary hearings are not held so as to open up the internal decision-making process. (This includes the Security and Exchange Commission, the

Environmental Protection Agency, the Federal Energy Regulatory Commission, and the Federal Communications Commission, among others). Undemocratic “back-room” deal-making would be a lot more difficult under a PUC-like regime because PUCs also have to write formal orders explaining exactly what their decisions are, and the basis for them, as rooted in the evidence presented in each case. Of course, no regulatory process can ever guarantee that the regulatory decision-makers will balance all relevant arguments and societal interests in a reasonable way consistent with the evidence presented to arrive at the true “public interest.” But such fallibility pertains even more so to private corporate decision-making by Boards of Directors and executives of corporations wherein balanced stakeholder input is rarely the case even for decisions with long-term social and environmental consequences for the public-at-large.

**Industrial Regulatory Boards and democratic control of investment.** In an earlier paper I have proposed that Industrial Regulatory Boards (IRBs) be established in each major industry along the lines of the PUC regulatory model as described above.<sup>2</sup> Each IRB would be composed of commissioners and technical staff with industry-specific expertise. Depending on the regulatory needs of that particular industry, each such IRB would have somewhat different responsibilities and types of authority to cover different sets of issues, as needed, to promote the public interest. The scope and depth of regulation would vary with the scope and depth of each industry with respect to environmental and social impacts. Diverse stakeholder interests would be represented at all levels of the IRB regulatory process.

The focus of each IRB should be to ensure that appropriate financial investments are made by each industry in a way that mutually reinforces the need to achieve key social and environmental goals over the coming decades, with mitigating climate change chief among these goals. In fact, given how little time the world has to mitigate climate change, water shortages, and the associated human dislocation, among other problems, it is inconceivable how unregulated and undirected corporate investment decisions could even come close to putting the world on a reasonably safe and certain trajectory towards climate stabilization, and sustainable development in general.

The IRB/PUC model would work in the following way. Whenever a business of significant size wanted to invest more than a specified minimum sum of money (e.g., \$10 million) in a new production facility for an existing product type, or to create a new product or service, they would apply to their industry IRB for approval of this investment. The IRB would seek further information regarding the investment, as it deemed necessary. If the investment proposed was relatively small and non-controversial, the IRB would have the authority to issue an order approving and/or modifying the investment without a formal hearing, but informal input would still be solicited from relevant stakeholders. If the applicant accepted the order, the investment could go forward. However, if the investment proposal was large and/or controversial, then the IRB would determine that formal hearings should be held. This would involve a full-scale review of the evidentiary and policy issues relevant to whether or not the proposal should be approved, with or without modification.

It is important to note here that generally the initiative to invest would come from either the relevant private or public corporation, and not from the regulatory body or the government. Thus, typically, no agency of the government would require that any new investment be made by

corporations. However, in other situations, a particular industry IRB might have certain legal responsibilities to achieve certain social goals, such as keeping the electricity system reliable. In such a case, the IRB might need to find either an existing public or private corporation that would be willing to make the relevant investments needed to achieve that social goal. If no existing corporation was willing to do so, a new public corporation might need to be established with governmental financial support to enable this social goal to be achieved. An example of where such a need might often arise is the need for more affordable housing for the poor and lower middle class.

Thus, the core motivation for the enhanced (or new) regulation of key corporate (and government) investment decisions is to ensure that society's scarce capital is not mis-directed, especially during the coming critical decades during which a massive "green" New Deal, among other investment programs, will be required to meet the world's pressing social and environmental goals.

**Different impacts, different regulatory regimes.** As discussed above, each industry is unique in structure, technology and impacts on society and the environment. This reality is the foundation for developing a range of regulatory "intensity" to meet society's sustainability goals. To illustrate, consider the four industries below:

- 1. Agriculture (patented seeds):** In the U.S., the full range of social and environmental impacts of new patented seeds has not been deliberated in an open PUC-like, methodical process, even though such issues have occasioned widespread concern and criticism in the NGO community. For example, no regulatory body, at least in the U.S., has the authority to take the impact of expensive patented seeds on the finances of farmers into account as a basis for restricting the production or creation of new seed types. Yet new patented seeds have stirred tremendous controversy both here and abroad, with regard to their social impacts as well as biological impacts.

If an Industrial Regulatory Board existed for the agriculture industry, the Board would also have to investigate the relationship between a company patenting certain seeds and the price they could charge for them. After all, patented seeds greatly reduce the possibility of competition among seed producers, and thus the possible exercise of market power has to be reviewed. Thus, patented seeds might have to be price controlled, so that only a fair rate of return on the relevant investments could be charged to customers. Also, of course, the social and environmental disruption that patented seeds might cause would have to be considered before such an IRB could approve any new seed products.

- 2. Chemicals:** In contrast to the fact that there are thousands of chemicals manufactured in the U.S. that have never been tested for safety, a chemical industry IRB would prevent such a situation from ever arising. The IRB could ensure this since it would have the power to disapprove any new chemical product if it were not in the public interest. Furthermore, since most existing chemicals are made from fossil fuels and other minerals, such an IRB could force producers to back off these raw materials in order to move towards renewable sources of energy and chemical feedstock such as biomass. Many, if not most, organic chemicals can, in fact, be made from biomass feedstocks. In

addition, chemicals made from unsustainable minerals could be phased out if other chemicals deriving from more sustainable feedstock would suffice in their place.

A chemical industry IRB should also set up a cycle of hearings in order to review whether or not the production of each existing chemical product should be allowed to be continued based on new evidence of its environmental impacts as they emerge. The ability to recycle or reclaim various chemical agents would also be a consideration in the Board's deliberations. Presumably, such a Board would adhere to a precautionary principle approach to such matters. Again, as with patented seeds, if a new chemical product were both patented and so unique as to lead to the likelihood of a quasi-monopoly in the market for such a product, then its price would have to be regulated, as well. Certainly, a chemical industry IRB would carefully regulate the location environmental impact of any new chemical factories or refineries. Finally, a chemical IRB could review national production levels of all chemicals in order to determine the need for all the chemicals currently produced.

- 3. Pharmaceuticals:** Even though the U.S. currently regulates drugs through the Food and Drug Administration (FDA), there are many weaknesses in the FDA's operations relative to how a full-fledged pharmaceutical industry IRB would function. First of all, an IRB could prohibit patented copycat drugs where substitutable generic drugs would suffice, in order to reduce wasted investment within the industry. Also, the review and approval procedures for each new drug could be significantly democratized through the public hearing process that all Boards would be required to utilize in most cases. This would allow citizen and civil society input into all decisions in a way that currently is impossible when drug applications are reviewed. Thus, citizen groups could call their own expert witnesses to testify in such hearings along with industry and agency staff witnesses. This would help break the current dependency of agencies such as the FDA on scientists whose work is funded directly by the industry that the FDA is attempting to regulate, a topic of much recent controversy.

And again, if the likelihood of a company having market power for any given product could be demonstrated due to its unique features, then the new IRB would regulate the price of this product, which is something the FDA has no current power to do. Neither the Federal Trade Commission nor the Justice Department currently makes such determinations as to the need for price controls for pharmaceuticals under U.S. anti-trust statutes. (Or, at least, such determinations are extremely rare.) Similarly, in situations where government research funds helped facilitate the discovery of a new drug, then a pharmaceutical industry IRB could force the relevant manufacturer to share its profits from selling that drug with the government.

- 4. Financial services:** In the wake of the economic crisis, a broad-based consensus has emerged calling for revamping financial services regulation. But beyond that general point, agreement on a detailed set of regulatory structures has yet to materialize. For example, almost no one is advocating bringing more transparent and democratic procedures to the deliberations of the Security and Exchange Commission, the Federal Reserve Board, or the Treasury Department. In fact, those agencies are notorious for



depending on fairly secret back-room deliberations and negotiations for making policy, with only certain industry insiders being consulted. That type of process must be replaced with open hearings where both expert and non-expert input is garnered. Financial regulation is no more or less worthy of being based upon transparent and accountable processes than any other type of regulation, except, perhaps, during periods of extreme crisis which, hopefully, better regulation will help avoid. The potential social impacts must also be accounted for when a financial industry IRB decides which financial products are safe enough to allow, and the risk profile of each product should be made well known to all industry actors. Furthermore, as with any other IRB, a financial industry IRB should be staffed with a wide variety of industry experts, representing the full range of policy positions on relevant issues. The same should be true for the financial industry IRB commissioners themselves. The Board commissioners should not be limited to financial industry insiders based on the implicit assumption that other stakeholders could not possibly understand the relevant issues. Furthermore, federal-level financial regulation would have to be synchronized with state- and local-level regulations in this industry or, in the case of the insurance industry, federalized altogether.

## **Conclusion**

The structure and function of all existing and future regulatory bodies needs to be re-thought from a clean slate. Most regulatory bodies should be more strictly restructured around specific industries or commercial services, so that those bodies can focus on developing the right centers of expertise to better inform their decision-making. But all basic industries and sectors of the economy, including government agencies, should be covered by enhanced regulatory processes.

With rare exceptions, all regulatory board proceedings and deliberations should be completely public, based on evidence collected broadly from all relevant stakeholders under the powerful mechanism of administrative law. Generally, regulatory bodies should react to applications from public and private corporations for investment and/or new product approval. Civil society participants should be eligible for funding mechanisms in order to help ensure a diverse range of such participation. This implies that industrial (commercial) regulatory boards might also have to regulate the prices for many products and services, as well as the environmental and social impacts of such products and services, if market power is found to exist in certain industries. This is because technological change and industry structure may allow certain providers of these products and services to be able to exercise market power in relevant markets, so that the pricing of goods and services could not be competitive. Finally, whether or not major new investments or new products and services are broadly in the “public interest” should be the guiding “bottom-line” criterion on which all regulatory decisions are ultimately based.

Regulation has long been defined in terms of maximizing damage control—namely, to limit the negative behaviors of business to ensure protection of the public interest. While to some degree this damage control mindset should be maintained, now is an appropriate moment in time to complement damage control with proactive, positive regulatory principles that are designed to achieve specific public purposes. With a broad spectrum of urgent social, economic, and environmental problems upon us, enhanced regulatory structures and processes stand as a key opportunity to mobilize all our social resources toward solving such problems, while at the same

time enhancing democratic process and consciousness. It is this balanced blend of damage control and proactive principles for achieving society's goals that should shape the purpose and structure of regulation in the coming decades.

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## **ENDNOTES**

<sup>1</sup> Please see [www.corporation2020.org](http://www.corporation2020.org).

<sup>2</sup> Rosen and Schweickart. 2006. "Visions of Regional Economies in a Great Transition World." Great Transition Initiative Paper Series. Boston, MA: Tellus Institute.