

# A THEORY OF REGULATION

## A Platform for State Regulatory Reform

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We who grew up in the cold war remember well our ninth grade civics picture of the Soviet state. We were told that you could not be what you wanted to be when you grew up. With special starkness, we could see a young Soviet boy driving a small pedal car up and down his sidewalk. A boy with eyes full of wonder about the big machines which hum down the cold streets. As he grows up he learns how the motors operate and he studies the various models year after year. He decides he wants to run a new automobile sales shop when he grows up. He wants to see and service the Ladka. He cannot raise capital and do it, the sales offices are government owned. He must apply for the position, or one which may lead to it.

In our cold war vision, before he applies, the Soviet youth faces a burly commissar, the quintessential bureaucrat. The boy walks into a sterile room of vaulted ceiling. He has waited for several hours for a 30-second interview. The commissar sheaves through a small stack of papers. Even before the boy reaches the lone chair in front of the desk, the official barks out his name and drones: "food factory canner, case receiver in tomato canning plan in Sochi....next." He then dismisses the boy with a curt wave of the hand.

Most of us have since learned that the repressive Soviet central planning system works less intrusively. Our young boy would not be instructed to be a case receiver. He would not be told at an early age exactly what occupation he would have to take. But he would be told what he could *not* be. If he wanted to be a Ladka dealer he could apply. With the help of the party, a committee is likely to formulate the requirements. Based on *their* view of how many dealers there should be and what they should do to qualify, they would say "no" to all but those persons they select.

Although not totally manipulating, the Soviet system imposes a "prior restraint": people cannot be what they want to be unless they are first given permission. They are not permitted to try on their own calculation of risk and let a marketplace defeat them based only on their failure to perform.

The year is 1984. The place, Thousand Oaks, California. One Paul Rusnak wishes to start a BMW franchise. It has been his lifelong dream. he has learned the auto business with great care. He has saved his money. He has secured the permission of BMW. He knows of many possible customers. He is sure of his market and proud of the product he wants to offer.

He is well aware that government bodies circumscribe much of what he can do: he must be licensed by the Department of Motor Vehicles and by the Bureau of Automotive Repair. He must advertise honestly, obeying the standards of the Federal Trade Commission and the Unfair Competition Act of California. He must honor his warranties and comply with the Magnuson-Moss Act and its state counterpart, the Song-Beverly Act. He must offer financing only under the strict terms of the Rees-Levering Act. And his automobiles must meet the emission standards of the state Air Resources Board and the safety standards of the National Highway Traffic Safety Administration. His own business operations must meet the safety standards of Cal-OSHA and the labor restrictions of the Labor Code. And, of course, he must pay taxes, keeping appropriate records. For local government, he must meet all land use conditions, ranging from parking requirements to the size and candlepower of his sign.

He is prepared to do all of that.

But there is yet another Board, one of many which Californians know little about: the New Motor Vehicle Board. This Board, set up by a trade association of existing car dealers, created a Board of seven members, three of whom are dealers. If any person, including a competing dealer, complains about the plans of someone to open up a new dealership, he or she may protest to this Board, which can then impose a “prior restraint” and say “no” to Paul Rusnak. This Board said no.

Many of us are well aware that lawyers and physicians must be “licensed” by state regulatory boards. And we justify this prior restraint by citing what lawyers like to call “irreparable harm.” We must make sure that certain trades and businesses do not operate unless they are competently conducted. This means both keeping out those who might cause severe public harm and excising those who are already in business whose performance falls below minimum standards. But it’s not just lawyers and the medical profession who are involved with prior restraints. Our New Motor Vehicle Board is not an anomaly.

The fastest growing and most intrusive part of American government rests within the so-called fourth branch: regulatory agencies. Created by legislative bodies and given quasi- executive, legislative and judicial powers, these agencies increasingly predominate in the lives of our citizenry. Much is written about the so called “alphabet soup” of federal regulatory bodies: the Federal Trade Commission (FTC), Civil Aeronautics Board (CAB), Federal Communications Commission (FCC), Securities and Exchange Commission (SEC), etc. Approximately 20 major regulatory bodies function in a relatively visible and open fashion in Washington, D.C., and through regional field offices. These agencies have been given enormous discretion by the Congress, which fashioned broadly framed mandates, and by the courts which have deferred to their expertise. They are subject to constitutional due process safeguards as to those they most directly affect. They are subject to an Administrative Procedure Act, a Freedom of Information Act, and other statutes. More important, their proceedings draw some interest from American journalism.

What is less known is that the greatest expansion in this fourth branch of government has occurred at the state and local levels, not at the federal level. Furthermore, the sometimes clear rationale for the development of regulatory bodies at the federal level has not guided state and local counterparts. State legislatures create new boards and commissions without considering economic rationale. They are viewed as “free” to the legislators authorizing them since they are “special funded” from the trade or industry subject to regulation. Legislators do not focus on marketplace flaws which might justify regulation, and the fashioning of specific means to compensate for or correct them.

Although new agencies are justified by consumer benefit, their initial proponents are often the trade group to be regulated. Where there is no one organized to oppose a new governmental body and it does not expend general fund monies, approval is not difficult. Legislators tend to count noses: who is for, who is against, and base decisions on the line-up. California now has over 60 regulatory agencies setting detailed policy in insurance, banking, utilities, transportation, and alcoholic beverage sales. Most of the trades are covered by regulatory agencies requiring licensure as a precondition to practice. In addition, agriculture has both state and federal (controlled regionally or locally) “marketing orders” government the promotion, distribution and/or supply of many agricultural commodities.

A typical citizen may be aware that local government regulates land use, that the Air Resources Board, Water Resources Control Board and California Occupational Safety and Health Administration affect the operations of many California businesses. Fewer are aware of the Milk Advisory Board, or the Board of Landscape Architects or the California Beef Council or the Bureau of Home Furnishings.

Co-extensive with a plethora of agencies, boards and commissions for purposes which are not clearly understandable, is the expansion of existing agencies well beyond what might have been a defensible original justification. The numerous existing agencies are very rarely monitored, or ever seen by any outside entity.

On the other side of the same coin is the issue of lack of regulation where regulation is warranted. And related to the problem of underregulation is the artificial creation of a marketplace flaw, the conferral of antitrust immunity and the avoidance of any meaningful substitute for the absent marketplace.

It is time to posit a rational basis for regulation, to develop some kind of defensible theory on which to base a regulatory system and to fashion its limitations.

## I. PRESUMPTIONS

Adherents of the Chicago “libertarian” school often define “regulation” simplistically as government interference in which would otherwise be a natural marketplace. It seems to be a libertarian thesis that the “state” is an inherently coercive and dangerous institution, possessing the power to tax, to draft and to imprison. These coercive powers make the limitation of the state *vis-a-vis* private power an essential concern of the citizenry. While there is more than a grain of truth to the libertarian presumption, the allegiance of its adherents to the symbols of the “marketplace,” without reference to the mechanisms which make the marketplace work, marks the philosophy as more of a religion than a rational tool for weighing options. The libertarians will often simply define “good policy” as a removal of government to a “marketplace,” without reference to what that might mean. It is accepted as an article of faith in the tradition of religious zealotry that the marketplace functions as a proper object of obeisance. Disciplines advocate the simple removal of those institutions which might prevent the “market” from achieving its “natural status.”

The world is much more complicated than this. In fact, the condition of the market absent government is the product of custom, language, pre-existing economic power—a human creation. And in fact, private power can coerce and enslave almost as much as the “state” can. Any resident of a one-company town will testify to the power of private interest. Large institutions may interrelate in an extremely adhesive fashion with the common citizenry. A serious marketplace choice may not be actualized. Private parties, increasingly cartelized, and horizontally organized into trade associations, may preclude marketplace choice and otherwise bully the consumer, the taxpayer, the citizen.

It is difficult for any but the most obsequious worshiper of marketplace symbolism to doubt the limitations of the unfettered market as a guarantor of economic freedom, equity or even efficiency. We shall explore the more traditional flaws of the marketplace that preclude its status as a blind object of worship below. However, to the extent it does function to manifest consumer sovereignty and allocation of resources according to informed consumer choice from a wide variety of alternatives, it is a touchstone deserving of presumptive status. Hence, we shall assume that where the marketplace functions to allocate resources efficiently and fairly, where the prerequisites are present for the marketplace to so function, it should be initially relied upon to that end. This reliance is related to the viability of its prerequisites. These prerequisites include the following traditional elements:

1. Many entrepreneurs acting individually and independently in buying and selling.
2. No one buyer or seller able to affect a significant market share.
3. Homogeneous products within types.
4. Perfect information about the characteristics of alternative products.
5. Rational decisionmaking by consumers.
6. No external costs which are unassessed by the marketplace.

Most regulation may be justified because of a breakdown of one or more of these factors, Although it is possible to exaggerate the impact of a marketplace deficiency, and to use it as an excuse to engage in unnecessary intervention, it is also true that where serious deficiencies exist in these prerequisites, the marketplace may not function to allocate resources fairly or efficiently. Where such an event occurs, it is inappropriate to rely on the mere absence of government as the solution. To the contrary, it is a primary function of government, as it provides checks and balances in our system, to intervene in order to restore or substitute for that absent prerequisite. The government should decline to do so only if the indirect and direct costs of that intervention exceed the benefits to be obtained from it. In determining what kind of intervention the government should choose, the benefits and costs of each must be measured. However, it is generally preferable to restore the marketplace, rather than to institutionally cripple it by providing for a substitute which may carry with it its own momentum and *raison d'etre*.

There are four major categories of breakdowns most often justifying some sort of governmental interference: (1) natural monopoly; (2) "scarcity;" (3) adhesive relationships, often accentuated with inadequate or misleading information; (4) external costs. The precise nature of a marketplace breakdown will dictate what is best suited to either restore the marketplace or to compensate for its absence.

## II. WHAT IS REGULATION?

Regulation is not a simply yes-no proposition. There are degrees of regulation. As we are using the term, regulation can mean intervention by the state at any one of three different levels. The most extreme level is "licensing." Here, a regulatory body prohibits the practice of a trade, profession or enterprise until or unless a "license" has been obtained from a governmental body. The existence of this license gives the state a basis for barring entry into the trade or profession, and through its denial, or revocation, confers an ancillary power to promulgate rules. Violation of these rules may be enforced through the draconian denial of that right to practice one's trade or profession.

At a second level, the state can regulate through a system of "permits." Here, no one can practice a defined activity until or unless they have a permit. However, as we are defining the term, there are few barriers to entry to obtain a permit. A system of permits allows entry simply upon the registry of certain required information so the "regulator" knows who is practicing. It gives that regulator the power to suspend or revoke such a permit if certain adopted rules of behavior are transgressed. A system of permits, although little used in the regulatory process, theoretically gives the system an easy in—easy out format. The regulatory body does not bar entry, but once an abuse occurs by a practitioner, the state has the authority to remove the practitioner.

A third level of regulation is "certification." As with "licensing," there is a barrier to entry in order to achieve "certification." One must pass certain tests or otherwise prove special competence in a field. But contrary to a license or permit, one can practice in that field without obtaining "certification." One simply cannot use a defined label or "title" unless one has achieved entry and proven competence. This option involves the state in measuring the competence of various practitioners in order to provide information to consumers by associating the use of a certain "title" with the level of competence that must be obtained in order to use it. A private entity can theoretically "certify" a person, e.g., the use of the term "realtor" granted by a private trade association. But only the state can bar entry by directly prohibiting practice of a trade without prior approval.

Regulation may also take the form of specified maximum or minimum rates. This regulation usually occurs in the context of a "natural monopoly," and then only in conjunction with a "licensing scheme" as we have described.

In addition to the regulation of rates, entry and title use, government has numerous other options where there is a marketplace flaw. Unfortunately, traditionally few of these options are considered. Of

course, prior to considering any regulatory alternative, the first priority should be to restore the marketplace by a “structural change” (discussed below) or by antitrust prosecution. Each of the remaining alternatives to traditional “regulation” has advantages and disadvantages, depending upon the marketplace flaw addressed. These alternatives include the following:

### **III. ALTERNATIVES TO TRADITIONAL REGULATION**

#### **A. Bond-Insurance Requirements**

A bond or insurance requirement may involve a barrier to entry implicit from its acquisition, but may not involve any further regulation. It need require no government-set standards beyond the bond itself. It is most appropriate where there is the likelihood of incompetence damage and a likely inability by the consumer to collect on a readily obtainable civil judgment, due to insolvency or otherwise.

A bond or insurance requirement guarantees that should there be a small claims court or class action judgment, there will be some recover. This alternative essentially allows the marketplace of bonding companies or insurance firms to regulate without government intervention. Where the courts sanction particular practices, the marketplace of bonds and insurance will reflect those decisions through higher rates or denial of coverage to those entities creating problems.

#### **B. Disclosure**

The second alternative is to require disclosure of certain information by business. Disclosure requirements often address information failures or adhesive relationships, but only where there are alternatives in the marketplace. This alternative depends upon a meaningful enforcement system to guarantee the disclosures are made.

It can suffer from inequitable application in situations where failure to disclose carries with it no consumer wrong. The mechanical enforcement of a prophylactic requirement which may often prove unrelated to the wrong being addressed can create injustice. Truth-in-lending may require disclosure of the total finance charge. A one dollar error to the benefit of consumers can result in the mechanical application of a sanction which could gratuitously injure a small business.

#### **C. Rule of Liability**

Another alternative societal measure can be a change in a rule of liability by common law evolution or legislative act. Hence, strict product liability may make it easier for victims to recover damages where there has been an injury. The rule of *res ipsa loquitur* has a recovery-enhancing effect. A governmental alteration of the rules of the marketplace, which are themselves the product of custom and state intervention, facilitates the internalization of certain kinds of external costs. The change may utilize the currently existing court system.

Altering a rule of liability carries with it the disadvantage of depending upon the existing court system with all of its drawbacks and deficiencies. These include: enormous transaction costs due to inflated attorneys' fees, interminable delay, often incomprehensible rules of procedure, and in the federal courts, an aversion to the only meaningful way of internalizing many modern external costs through the court system: the class action. Of course, standards of licensing agencies are also rules of liability implicit in the licensing system and are discussed below. These standards are subject to confirmation in the courts and to their own procedural inefficiencies.

#### **D. Straight Prohibition**

Yet another alternative is deterrence by formulating broad marketplace rules grounded in fundamental fairness, and the punishment of those who transgress. Sanctions are based on the degree of transgression, the amount of unlawful gain and the extent of harm caused. The use of criminal prosecutions for consumer fraud is an example of such a deterrent-producing alternative. Generally, the deterrent-producing criminal prosecution alternative is under-utilized, even where the harm may be egregious, apparent and the result of *mens rea*.

#### **E. Tax Incentives / Disincentives**

Another form of societal intervention is through tax or fee incentives or disincentives. A tax incentive may be viewed as a public appropriation of funds to the extent it defers or excuses taxes by one person performing certain favored acts *vis-a-vis* others. Instead of not taxing citizen X \$10,000 by allowing a deduction or credit for a favored private expenditure, we might instead simply take the same amount of tax money from all parties, and then turn around and hand citizen X a ten thousand dollar check. This mode of analyzing tax loopholes, terming them "tax expenditures," is now widely accepted. Tax incentives, although they produce a strong pull on private behavior, use a bureaucracy: the existing tax bureaucracy. Where this tax bureaucracy has excess capacity and economies of scale justifying further use as a cross-subsidy, it may make sense to use it. And it may also have the advantage of allowing allocation decisions to be made by many private actors in a kind of favor dispensing marketplace, rather than by a government agency.

However, there are several important deficiencies in using the tax system to accomplish cross-subsidies to stimulate or discourage behavior. Because of the progressive nature of the tax system, any tax incentive by way of deductions reduces the progressivity of the system. The tax deduction literally awards one person a greater benefit based on taxable income. Even a tax credit, which overcomes this difficulty, is limited since there are large numbers of people who do not pay taxes and cannot take advantage of the benefit.

Tax incentives or disincentives have a more serious deficiency. A tax incentive, once enacted, continues without further examination. It is often unclear how much it is costing. It does not automatically end until it is affirmatively removed. The benefits are received invisibly and without public scrutiny. If we had to appropriate the \$10,000 for Citizen X, we would see who was getting it, why he was getting it and how much he was getting. If we had to give that money year after year, making that threshold decision to so appropriate it repeatedly, we might not make the same decisions we are making through the tax code. Of course, quite apart from the hidden nature of the subsidy, and its proclivity to continue unless specifically ended, we have its contribution to further complexity and inequity in a largely incomprehensible tax system. The current system undermines the legitimacy of all government, and indeed the allegiance of its citizens to the state.

#### **F. Sale of Marketing Rights**

Related to tax incentives/ disincentives are the possible sale of marketing rights. The state simply declares a given output allowed and then allocates excess demand to engage in that output by auction. The system is to create an artificial scarcity and allocate the permitted quantity by sale, either by letting those with current rights sell those rights in a marketplace, or by public auction.

#### **G. Subsidy**

The state can prevent an external cost or stimulate an external benefit by the obvious device of a direct subsidy. Or it can accomplish the same end with a more seemingly appearing loan guarantee, supply limit, direct government purchase, government storage or marketing assistance, import protection, et al.

Despite the disadvantages of each of the seven alternatives we have listed, one or more may be superior to a system of comprehensive regulation. Indeed, the lesser forms of regulation described above may be superior to the more traditionally invoked “licensing” systems currently in vogue.

#### **IV. COSTS OF REGULATION**

The traditional comprehensive “licensing” mode of regulation has numerous costs. First is the cost of the regulation itself. Examination licensing fees, renewals and gate taxes, etc. are imposed industrywide by a board or commission under legislative authority. These direct costs of regulation are passed on to the consumer in the form of hidden taxes, although consumers may not identify them as such. Monies are not taken from the general fund for the purposes of financing most occupational licensing regulation, and hence these direct costs are not recognized by legislators either.

The second cost is an indirect cost, but is much more momentous than the direct cost of regulation. The barriers to entry which are created keep out of a trade or industry those who might compete. There is a cost in the denial of entry to those who would otherwise be practicing. There is the cost of overcoming the barrier by those who surmount it. There is the additional cost of the rules which are often promulgated. Because of some history of abuse by a practitioner, the legislature may categorically impose a barrier and exact a serious cost to the system as a whole.

Where there is an alternative more narrowly directed at a wrong, either by rulemaking or by some non-regulatory alternative, the cost may be unnecessary. There is a certain paternalism which pervades regulatory agencies over time and which has been the subject of much scholarly comment. When the optometrists of California were required to take CPR as a condition to obtaining an optometry license one begins to see the general trend.

The California Athletic Commission’s concern about too many complimentary boxing match tickets to friends by certain promoters led it not merely to ban excessive gifts of tickets but to the licensing of ticket takers, ushers and even ticket printers! There is a large universe of examples of *in loco parentis*, often well intentioned, and often costly.

Perhaps the final cost is the cumulative effect of closing a large number of occupational and business opportunity doors before they can be tried. The notion of “prior restraint” imposed by the “state” — a kneeling servility to a bureaucratic official before one can start a commercial venture — is antithetical to the American character. Because someone somewhere has done someone wrong, you must be prevented from doing wrong — a wrong you have not done. So you cede to the state the right to deprive you of the chance to offer your services or products unless it thinks you are not likely to do wrong. The American tradition has been: let me do what I want. if I do wrong — then intervene, unless the wrong is so terrible and the state’s accuracy in predicting who will do wrong justifies a contrary rule. No one categorically precludes prophylactic state intervention, but, rejecting the presumption of state paternalism, we better have a clear and damned good reason for it.

#### **V. A FORMULA FOR JUDGING REGULATION**

##### **A. Presumption**

Rather than using the current formula for evaluating the appropriateness of a new regulatory system by state legislatures (let’s count noses, who is for it and who is against it), we might consider some form of rational analysis.

The appropriate societal response to market deficiency depends upon many variables. The first presumption is to employ the market to the extent it functions. This means the restoration of the market. If a market prerequisite is missing, perhaps it can be resurrected, or artificially supplied, to allow informed consumer sovereignty. One has a leak in the basement. One can hire workers to mop, and perhaps regulators to shut down the main water line when water is not needed for showers, drinking or watering. Of course, these moppers and regulators may become a regular part of a rather bloated household budget— unless we can work out a way to socialize their cost. Translated, this means getting others to pay for your lousy plumbing. One does not have to be a libertarian to propose calling in some plumbers, fixing the leak and then getting out of the house.

And our presumption has a corollary: pay for it yourself—unless we are prepared to subsidize a noble end, in which case the gift should be visible, debated and cease unless renewed annually.

## **B. Prioritization**

Chart A presents a rough ranking of societal responses to the five types of market flaw traditionally justifying regulation.

### **1. Natural Monopoly**

A natural monopoly exists, put in the simplest terms, when there is room for only one entrepreneur to operate efficiently, usually because of economies of scale. If it takes a billion dollars to acquire railroad or utility rights of way and there is room for only one such system, or only one is needed to carry all expected traffic, there may be a natural monopoly.

The priority societal response to a monopoly should be to try to restructure the enterprise to make competition meaningful. This could mean allowing new railroads to compete on the lines of another railroad in return for a fair rental charge for using their lines (called “wheeling”). Of course, government intervention would be required to set a fair rental charge.

It could mean public purchase and management of those aspects of the enterprise with high initial fixed costs (which create the economies of scale and the natural monopoly format). Hence, if the government owned railroad rights of way, track and switching facilities, the actual railroad carriage could be undertaken by competing lines. Technological change may also undermine natural monopoly by creating substitutes for the high fixed cost parts of previous monopolies (e.g., long distance telephone service by microwave/satellite).

Where natural monopoly is inevitable, there is no competition, no natural selection of the most efficient entrepreneur, no competitive price. Once monopoly has been conceded, unless allowed for a limited period as a special socially beneficent reward (e.g., patent awards), there must be maximum rate regulation to preclude excess profits. Note that most natural monopolies are the result of government intervention to facilitate the enterprise (use of land grants, eminent domain powers, et al.).

Maximum rate regulation is not enough to preclude natural monopoly abuse. Lacking any competitor, the monopolist can give short shrift to consumer service, can become inefficient in operations, secure that most expenses will be compensated. The regulator is in a classic catch-22 quandary in attempting to provide an incentive to incompetent monopolists to improve. Although the regulator may inhibit monopoly power profits, it is obliged to provide the utility’s private investors a “fair rate of return” on the investment. More important, the regulator knows well that the long run service depends upon the ability of the utility to attract capital for plant improvement. The denial of an attractive rate of return jeopardizes this utility asset. Yet most regulators believe that the only weapon they have with which to police or discipline utility imprudence is to



deny requested rate increases. In so acting they are forced into the cliché to cut off their noses to spite their faces.

Natural monopoly regulation has suffered from a lack of imagination. In the private sector, a failure to perform results in an immediate impact — declining profits. This translates into lower dividends and the dismissal of management. There is a “natural selection” labor market in the competition for superior management. Unfortunately, there is little precedent for regulatory replication of this time-honored marketplace check, but it is easily accomplished.

Theoretically, a regulator could give an existing management group sufficient time to perform efficiently based on comparable market based standards. Repeated failure to achieve reasonable performance results in the conditioning of a future rate increase on the replacement of upper management with a new group. This is what the free market would do. The regulators do not specify who should be hired, just that there must be a change. The extremely well paid executives of a monopoly utility hold a position without tenure. They have a special duty to perform—since they function without immediate market challenge and often manage the provision of a necessity. As benign as the simple recognition that these positions are not lifetime sinecures may appear to be, there is a universal refusal to choose this regulatory option, even with the most egregious record of executive nonfeasance.

The third alternative, government ownership, is a last resort. The confluence of industry and the state removes a fundamental check in the American system: the independent state. With that precious independence, the citizenry can break through what might otherwise be a coordinated curtain of apologia or deceptive self promotion obscuring failure.

## **2. Scarcity**

The paradigm example of scarcity-based regulation is FCC licensing of radio and television over-the-air frequencies. There are a limited number of non-interfering stations and in many areas more entrepreneurs want to operate than can be supported. How do you decide who gets to broadcast or telecast? You do not need to limit maximum rates because there is presumably sufficient price competition. But there may be reasons why one does not want to simply allow those who got there first to have or keep these necessarily scarce resources.

The preferred method for allocating scarce resources is by auction. Leasing or selling these scarce resources to the highest bidder does two things: provides public revenues and allocates them to those willing to pay the most — willing to take the greatest risk or able to attract the most capital for the venture based, presumably, on their track record in anticipating consumer demand. To be sure, we may want to advance interests outside consumer demand, but if so, we should be willing to do so by direct and open subsidy.

The allocation of scarcity in the case of FCC regulation purportedly is based on “qualification.” Licenses and renewals may be subject to competition along criteria designed to run consonant with the “public interest.” In actual practice, with rare exception, the system is actually a “first come first served” system.

The least desirable method of scarcity allocation was illustrated in the gasoline shortages of the late 1970s. Artificial maximum prices prevented market allocation. Supplies were therefore allocated consistent with the Soviet practice: those willing to wait in lines the longest receive the service or product. Limiting demand by making those who wish to purchase something waste enormous quantities of productive time may be one way of seeing to it those who “want” it most (or who have no other demands on their time) get it, but is not the method of allocation favored by a rational society.

### **3. Adhesion / Imperfect Information**

Much of consumer law is concerned with common adhesive relations between merchants and unorganized consumers. Take it or leave it boilerplate contracts imposed on consumers by merchants who spend their livelihood formulating them to their best advantage, has meant abuse. These abuses are often invoked to justify regulatory systems.

Certainly where advertising is misleading, public civil and criminal remedies abound, at least in theory. The preferred remedy is competition: competitors challenge each other's advertising claims with counter advertising and provide product alternatives. And public education funded by the state may increase the consumer's ability to evaluate conflicting claims. Such an effort is especially warranted where purchasing decisions cannot be made easily by individual consumers. How does a consumer evaluate conflicting claims of tire longevity? The consequences of diet choices?

Notwithstanding vibrant competition and public education, imperfect information may warrant further intervention.

It is possible to identify certain kinds of transactions particularly subject to abuse. The most common of these has been in the area of consumer finance. Hucksters advertise "8%" financing but fail to mention that 90% down is required for that rate; others advertise only "5%" down and fail to disclose high interest. A federal truth in lending statute was passed to require amount down, period of payment and interest rate if any one of these three is mentioned in an ad. Although an arguably helpful requirement, the statute then excluded any civil remedy for that requirement.

More typical are the direct "disclosure" requirements of Truth-in-Lending and many state counterparts at point of contract. In one reported case, a consumer bought two trucks with \$700 down on each as the disclosures represented on the contract. Because the consumer submitted a check for \$1,000 and two others for \$200 each, the statute was violated and the merchant severely sanctioned. Certainly requiring standard disclosures may help the marketplace and reduce the need for more intrusive forms of regulation, but the disclosures must be related to consumer need and the remedies must be measured against the wrong. It is better to have a general standard of fairness and hit egregious conduct with harsh sanctions in widely publicized cases than to impose debilitating sanctions on merchants for mechanical bona fide errors of no important concern. Every unnecessary merchant limitation and requirement imposed across an industry or trade is a cost imposed on all consumers.

Where disclosures will not suffice, certification is a possibility. Consumers cannot test many kinds of products individually. Marketplace information about the performance of an automobile in a collision cannot be obtained by buyers directly. The selection of a competent urologist may be a difficult task. In many cases, private groups ranging from Consumer Reports to Underwriter's Laboratory conduct testing to rate and certify performances. But many complex services or products may not be amenable to private testing, and may justify public testing and promulgation of results (as with auto crash results) or publicly funded testing and certification for a "title use" to facilitate consumer marketplace information.

### **4. External Costs**

External costs occur when the purchase or use of a product imposes costs on others which are not reflected in the price of the product. Typical examples include various forms of pollution, hazardous products imposing injury or death losses on others, and incompetent practitioners of essential professions or trades who injure those entrusted with their care. "External costs" justify most state and local regulation! Power plant A produces widgets and pollutes both the air and the water while doing so. Power plant B also produces identical widgets, but controls its pollution. Power plant A passes on certain costs to the environment, fishing

interests or to the health and safety of future generations. These costs are not borne by the factory and hence are not internalized in the price of the product. The widgets produced in Factory B may cost a small amount more because of the controls preventing such pollution. Because this cost of control is included in the price of the widgets produced by Factory B, it is driven out of business. Factory A survives, even though the total cost of its production of widgets, including the cost imposed on others through the production or use of the product, is much greater than Factory B.

A possibly preferential way to deal with this flaw is rarely used: the compulsory tie-in. There is a harmful effect in the production or use of a product which is assessed outside the marketplace. Try to find a way to bring it into the marketplace by adjusting market rules, *e.g.*, internalize the cost by direct tie-in. Take, for example, the non-fatal auto accident mission of the National Highway Traffic Safety Administration. We are talking about routine equipment standards, *e.g.*, bumper strength for front end collisions. One can create an agency, hire experts and government civil servants, buy a series of office buildings, buy equipment, meet, hold hearings, establish standards for proper bumper production, inspect bumpers which are produced, test them against those standards and sanction those who fail to meet those standards.

On the other hand, one could simply declare that each automobile sold must include insurance according to very simple minimal standards of collision coverage. No bureaucracy. No standards. No enforcement. Those bumpers which result in the front end self destruction of their accompanying vehicle at a bump under 5 mph (most current vehicles), would and do have horrendous insurance costs. But the manufacturer would have to pay them directly. At present, the external cost of gratuitous damage is cross-subsidized since imperfect information means that after-the-fact damage requires replacement parts whose production is dominated by the manufacturer. The high initial investment in the auto means a partially captive market leading manufacturers to set prices for extraordinary profit. The insurance tie-in requirement means that a manufacturer who designs a useful bumper will be able to offer insurance at a much lower cost than self destructing bumpered autos. A vehicle with a better bumper is quite likely to cost less than one with a worse bumper, giving it a strong competitive advantage. If it does not obtain a competitive advantage, perhaps the cost of the better bumper is not justified.

The goal of the “tie-in” approach is to internalize external costs to let the self-regulating market determine the nature of the ameliorating action taken. There are other ways to accomplish the same end more efficiently than regulation with accompanying prior restraints.

Often, the tie-in cannot simply be legislated. Pollution is a paradigm case. We have listed in Chart A five kinds of measures to accomplish a tie-in or otherwise to ameliorate external damage: tax transfer, marketing rights sale, equipment standards, harm or output standards and a rule of liability enforced through the courts. We believe that the last alternative, often used, is among the least effective or equitable, but preference among the remaining measures is more difficult. We have expressed a certain ordering of priority, but qualify it by briefly explaining the advantages and disadvantages of each:

*a. Tax Transfers*

Where the harm increases in a relative straight line as the externality increases and where the harm can be measured, it may well be amenable to a tax or fee. Germany and France have used such a technique with some success in pollution control. Pollution emissions from a plant cause variable harm depending upon: the substance emitted, the atmospheric conditions in the locale, the kind of environment receiving the emission and, as many systems ignore, the synergistic effect of pollution mixes, including background pollution. Tax systems can adjust to at least some of these variables.

As with the three measures discussed immediately below, the remedy suffers from the conflict

between an easily administered generalized tax by substance emitted and “individualizing” the tax. Theoretically, it could be varied according to: harm caused from a particular substance at a particular location at various levels of background pollution mixes. And it also suffers from the problem of monitoring and accurate assessment.

However, these difficulties are manageable. Perfect external assessment, as with the perfect due process, is a standard for measurement, not a minimum for action, and perhaps never completely achievable. Focusing on the imperfection of a system to correct a marketplace defect distorts the rational inquiry: what are its relative merits compared to the alternatives. The problems of a tax/fee system are formidable. If the rates are to vary by damage category in any detail, a regulatory body will likely have to set them, exercising expertise from specialized staff resources, engaging in public rulemaking hearings. To the extent the rates perfectly reflect individualized harm from emissions, they would vary literally by emitter and could be subject to the political process of advocacy from those larger entities able to afford it. One could even imagine the broadening of the tax-setting deliberation to include the tangential external costs of the tax itself — perhaps the closing of a plant which might entail some alleged externality.

In point of fact, if a polluter is using certain equipment and produces items by known processes, which is usually the case, it is possible to establish presumptive levels of emission. This is how the tax systems of Europe avoid the monitoring dilemma. It appears to be workable, although understandably imperfect. Likewise, the tax may well vary by pollutant and region without difficulty, and approximate the harm caused.

While most other forms of internalization have these same defects, they generally lack some critical advantages to taxes/fees. First, the tax/fee system is efficient. It does not depend upon detection, onerously expensive due process hearings for breach of standards, followed by assessment of unpredictable penalties. The sanction is relatively certain and calculable. Second, the system is continuous. As emissions increase, taxes increase and incentives to install controls may increase. Third, the system does not preclude new technology to control pollution — it stimulates it by providing an incentive-based demand. Fourth, the system misallocates resources less than alternatives by allowing certain emissions where the cost of reduction is extraordinarily high, while the marketplace first reduces emissions where they are gratuitous and more easily cut. Fifth, the system is capable of fine tuning. One can start the system at a politically acceptable low level and gradually increase until major reductions occur, or perhaps gradually decrease as overall air or water are clean enough so that their self-cleansing properties may allow for more emissions of certain types.

Finally, the system generates revenues which can be used to compensate the interests suffering damage from the emissions of those who choose to pay. The assess and pay dual aspect of a tax/fee system is especially attractive. In a sense it can accomplish what rules of liability attempt, except by automatic process without the need for detection, affirmative action by a sophisticated victim or public entity and without costly judicial proceedings.

It is important, however, to establish in advance where the taxes are going, or at least the criteria for tax adjustment. This information enables the private decisionmakers to make more rational decisions. One does not have the spectacle of auto emissions standards tightened so slowly and incrementally that the efficient stratified engine capable of meeting stringent standards is eschewed in favor of a clumsy technology of pollution control devices to meet what turn out to be interim standards.

#### *b. Sale of Marketing Rights*

The “public sale of marketing rights” shares many of the advantages of a tax/fee system. This remedy is appropriate where the harm done is closely related to some identifiable quantity of output and where at a certain level, the harm jumps in a curvilinear fashion. If we decide that if we have more than 1,000 taxi

cabs serving the airport, the congestion creates an intolerable external cost due to lack of space for them, we can auction off the right to serve the airport to 999 cabs. If the emission of more than 500,000 pounds of sulphur dioxide per year in a given locale exceeds the self-cleansing properties of the atmosphere and creates intolerable harm, we can sell the right to emit sulphur dioxide up to the level, and compensate those possibly affected by more tolerable harm.

### *c. Standards*

Equipment standards and performance standards may be needed where simple prohibition may not be effective by direct criminal or civil liability by statute. These latter remedies may be sought where there is irreparable harm from the breach of definable standards and are discussed below. But it is also possible to set standards administratively through rulemaking to discourage an external cost. It is generally a power implicit in the general power to control entry through the granting of licenses (*e.g.*, certificates of public convenience and necessity). The option of standards allows non-economic prescriptive rules of behavior. They are advantageous only where detailed control is needed, detection of violations is workable and the administrative sanction is efficiently applied or is deterrent-producing. Although there may be some basis for the use of standards to prevent forms of irreparable harm which come from their breach, as a means of internalizing external damage, it generally suffers from inflexibility and inefficiency.

The setting of the standards themselves has the problem of “generalizable rule versus individualized rule” in our tax/fee discussion, except the means of enforcing standard violations makes it more difficult. Should we limit sulphur dioxide total emissions in an area? By plant? By smokestack? Should we vary emissions if a given polluter is producing something which can be made nowhere else and the cost of lessening his emissions is enormous? Should we start granting exceptions? What often happens is the standard-setting system ends up describing through its standards what already exists, with little impact on the external damage. Additional emissions may be discouraged, but the same result would be achieved by freezing emissions at current levels and marketing the right to emit by public sale or from an entity currently emitting.

Where standards are set in too generalizable a manner they may misallocate resources and produce inequitable results. Enforcement is quasi-adjudicatory in nature and invokes the full panoply of due process rights. Due process may condition the sanction on years of discovery, hearings and appeals. Ironically, the chief weapon of the standard enforcer is the enormous cost of exercising these vaunted due process rights. It is precisely because they are too expensive to exercise that the standards have some efficacy. However, where the stakes are high for a private entrepreneur (*i.e.*, under circumstances where the standards may have real import) the cost to the agency to establish the sanction is also high. As the disciplinary records of current state agencies make clear, very little enforcement of standards actually takes place. It is the likely disapproval of one’s peers or the public from a prosecution, its cost (and in small measure the possibility of a draconian albeit rarely used license revocation) which gives standards what impact they have.

“Equipment” standards, rather than performance standards, limit many of these problems. However, requiring certain equipment or its equivalent can be accomplished without much regulatory presence beyond the approval of “equivalents.” *I.e.*, any equipment requirement should allow for substitute technology “equivalent” in performance to any existing equipment then specified. Review to warrant equivalence should be subsidized to encourage technological innovations. Such an equipment standard is appropriate where a certain kind of equipment precludes an unacceptable minimum external cost in a direct and equitable way, or where there are irreparable external costs without it, discussed below.

*d. rule of liability: judicial assessment*

One may create a rule of liability which allows those injured by Factory A to file a lawsuit and to use the existing bureaucracy of our legal system to internalize the cost of that damage into the price of the product by assessing damages against Factory A in court. A corollary way of accomplishing the same end is to simply ascertain the amount of damage being caused by Factory A and levy an assessment which would be internalized in the price of the product produced, as we have discussed above.

Whether the assessment is properly made by court adjudication, regulatory process or a more automatic tax levy will turn on a number of variables: the degree and diffusion of the external cost, its ease of calculation, et al. In general, the court system is a poor means to assess such costs where they are regular or widespread because of fundamental deficiencies in the American judicial system: lack of access by the poor or middle class, hostility to the class action mechanism theoretically able to accomplish internalization, unpredictability, the transfer of the dispute into a contest of resource exhaustion and delay, and overwhelming expense. Should a reasonable system of dispute resolution be created, it might be able to internalize costs more effectively. In some jurisdictions, easily detectable damage may be addressed where small claims reforms, alternative dispute resolution experiments or class actions occur meaningfully.

## **5. External Costs: Irreparable**

### **Harm**

There are some external costs which cannot be “assessed” by any means of internalization satisfactorily. Attorneys have a concept: “irreparable harm.” What do we do about harm which is unacceptable even if it can be paid for? Or harm which simply cannot be paid for? The law allows for preliminary injunctions in civil cases where such harm may befall one of the parties—where the “remedies at law,” e.g., money damages, are “not adequate” to provide relief, et al. There are obvious examples at the extremes. Nuclear safety is not a matter to leave for later damage assessment. The harm is irreparable, it must be prevented. Automobile collisions at high speed kill 40,000 Americans or more each year and disable many thousands for life. Preventive action would appear warranted. A consumer entrusts his life to a surgeon and preventive measures to assure a competent professional can be justified.

*a. mechanical tie-in*

The first checkpoint is the possibility of a “mechanical tie-in.” Unlike the tie-in designed to internalize compensable damages, this tie-in seeks to prevent an uncompensable cost. In the case of our automobile, a mechanical tie-in may consist of a simple requirement to equip vehicles with air bags. Assuming a benefit-cost ratio can justify a mechanical tie-in, which is rather obvious in the case of the air bag, it can be imposed with a minimum of ancillary or misdirected restraint. As we have noted, it is important to qualify any such equipment requirement with an “or its equivalent” option, requiring regulatory review to certify equivalency; and there is a need for some enforcement means to assure compliance. But these tasks are focused, relatively easy and non-intrusive. They minimize the continuing generalized presence of government over an area of commerce and inhibit the kind of *ultra vires* extension and institutionalization of public bodies of control. And they are usually more effective in accomplishing their focused goals.

*b. standards: civil or criminal prosecution*

There is no set of equipment which will easily assure the safety of a nuclear power plant, disposal of hazardous wastes or the competence of a surgeon. For many practices which are simply unacceptably dangerous or harmful, a secondary approach might involve the issuance of a straight prohibition or mandatory instruction by statute, if easily articulated, and subject to preliminary relief and deterrent-producing civil or criminal sanctions as appropriate. The disposal of certain listed waste products must be made at specific sites where they are neutralized at a cost borne by those disposing of the products. Where

(1) violations are prosecutable without the examination of the defendant, (2) the harm is attributable to individuals deciding to impose an irreparable harm on others, and (3) the danger is substantial, criminal remedies may be appropriate. Where one or more of these factors is absent, a public civil prosecution buttressed by the powers of preliminary injunction, restitution and civil penalties may be preferable. In some circumstances, a private cause of action may be used to assure adherence to a straight prohibitory rule with relaxed standing requirements and “private attorney general” attorney fee award provision.

Where the external harm requires complex and changing prohibitory conditions, e.g., the construction of a nuclear power plant, an agency may be needed to adjust and apply detailed rules of operation with expert staff guidance. Here, the agency applies the rules and the primary remedies for non-compliance, under general statutory authorization.

*c. standards: licensing*

The final alternative for external costs where there is irreparable harm is the licensing of a trade, profession or area of business. A board, commission, department or bureau prohibits business operations unless and until prior governmental permission is given. This prior restraint is justified so a public agency can filter out those who would cause irreparable harm. The same public purpose gives those public bodies the obligation to excise those who were admitted but who manifest the same danger. We have cited medicine as an example of a justifiable prior restraint, but there are non-health related candidates as well. An incompetent attorney can cause serious irreparable harm and a large number of such practitioners could threaten the efficient operation of a legal system which requires a high level of expertise. As with law, most non-health rationales for prior restraints involve: (1) the consumer lacking adequate information from which to evaluate competence in his or her own self interest, (2) serious irreparable harm flowing from such incompetence, and (3) ability to exclude the incompetent.

## VI. FUNDAMENTAL MIS-REGULATION

Using California as a case study reveals a symptomatic array of mis-regulation, not only by the theories set forth, but by any articulable theory.

### A. Excessive Licensing to Ameliorate Incompetent Practice: Prior Restraints Gone Wild

The public knows little of the extent of regulation at the state level, nor of the indiscriminatory reliance on the last resort alternative of comprehensive licensing with prior restraints. For California does not just license doctors, dentists and lawyers. It licenses: landscape architects, accountants, boxing promoters, boxers, wrestling promoters, wrestlers, architects, barbers, counselors, psychologists, morticians, collection bureaus, contractors of all types, cosmetologists, polygraph examiners, personnel services, dry cleaners, geologists, geophysicists, nursing home administrators, optometrists, land surveyors, nuclear engineers, petroleum and other engineering title use, shorthand reporters, veterinarians, structural pest control operators, insurance agents, real estate brokers, auctioneers, chiropractors.

Further, within each of these licensing systems, enormous expansion has occurred over time. The Board of Fabric Care began by licensing dry cleaners; now it has separate approval for those who clean hats, those who clean furs. The dental regulators have expanded to license not only those who clean your teeth, but “dental auxiliaries” who put on your bib and show you where to spit. The regulation of boxing promoters resulted in the full scale licensing of everyone connected with the enterprise: matchmakers, timekeepers, even announcers...even the ushers! The Contractors State License Board is playing with separate licensing for each possible trade specialty: brickwork, dry wall taping, solar device installation, etc.

More remarkable has been the continuing addition of new comprehensive licensing systems. There has been a great deal of publicity given to “deregulation,” particularly by Republicans. Liberal Democrats

have hailed the notion of “sunsetting,” setting a date at which time an agency will automatically terminate unless it can affirmatively justify its existence. In fact, we have not been able to find a single licensing agency which has been deregulated significantly, nor one which has been effectively terminated within the past two decades. Even the source of the deregulation “sunset” movement, the state of Colorado, has failed. Although five agencies were terminated amidst much hoopla in the 1960s, we have traced the subsequent reappearance of all five. The trend has been in the opposite direction. And the efforts to expand this most intrusive form of regulation continue unabated. The last several years have seen serious bills to set up yet new boards to comprehensively license: “aestheticians” (people who advise on proper make-up), interior designers (people who advise on attractive interior decor), travel consultants, financial advisers. The most recent bill we reviewed proposed to license “recreational therapists.” What is this? Those who: initiate, prescribe, direct, evaluate, educate or participate in any treatment involving “social, play, recreation, sports, game, or leisure oriented activity.” Or it means anyone “using leisure education, leisure counseling, activity analysis, and leisure assessment.” Or it means anyone else who performs: “any service requiring substantial specialized judgment and skills in the use of recreation activities for others based on the application of knowledge of principles of biological, physical, social, psychological sciences and recreation leader studies.”

The list of currently licensed entities above is not meant to imply inappropriate government involvement in every case. For some, even a licensing system may be justified. But for most of them there is no justification for licensing under any theory, and for many of them, no need for any extraordinary government involvement. For many agencies with easily recognizable external costs, some irreparable, e.g., the Occupational Safety and Health Administration (Cal-OSHA), water and air pollution control, we may wish to weigh the benefits and costs of the mode of regulation employed. But for many of the occupational and business licensing systems, they flunk a threshold test.

Chart B, below, includes an outlined listing of the regulatory abuses currently extant in California, allegedly a “model” state. The first columns indicate initial errors in regulatory format.

#### Threshold Test 1: Market Flaw

There is intrusive regulation, including prior restraint licensing, of dry cleaners, barbers, cosmetologists, shorthand reporters, et al. These trades are illustrative of not only low levels of irreparable harm, but of a generic need for repeat business. No drycleaner or barber will remain in business long while incompetently disappointing successive populations of new customers and losing their repeat business. The performance of the tradeperson is readily evaluated by the consumer. The marketplace has no flaw justifying any intervention.

#### Threshold Test 2: Irreparable Harm

A second threshold test is the existence of sufficient irreparable harm to justify the extraordinary option of blocking entry. Does some incompetence by a landscape architect (persons who plan gardens for hire), a collection bureau, an appliance or electronic repairman, a retailer of bedding (or the drycleaner or barber or cosmetologist needing repeat business) create likely irreparable harm? Are not money damages sufficient? Note that these entrepreneurs are subject to Cal-OSHA regulation for safety and are prohibited by criminal and civil statutes from deceptively advertising or defrauding consumers.

#### Threshold Test 3: Possible Assurance of Competence

A third test is the ability of the state to assure competence, at least in theory. Can the Board of Behavioral Science Examiners or the Psychology Examining Committee assure competent counselors or psychologists? By a written test? Is the state going to be able to set proper standards for make-up application for “aestheticians” or advisable interior decor of building for “interior designers?”



#### Threshold Test 4: Inability of Consumers to Judge Competence

There is a fourth group of trades improperly licensed. A number of these may involve encounters between consumers and trade persons where there is *not* a critical need for repeat business because of the one-time nature of each encounter. And there is sometimes the possibility of irreparable harm, perhaps even thought to warrant government intrusion of some sort. But are these situations where a final threshold test is met, an ability by the consumer to evaluate competence? Is assistance from the state needed because the consumer will be unable to make the evaluation himself? The Board of Landscape Architects has considered expansion to license “golf course architects.” How many consumers need the assistance of the state to pick a good golf course architect? Are those who do this hiring in need of such assistance, even assuming irreparable harm from incompetence? What about collection bureaus? Geologists? Geophysicists? Petroleum engineers? Shorthand reporters? Auctioneers? Auto dealerships? Nuclear engineers? Who decides to hire or use these people? Is the role of the state here the assurance of competence or the reduction of competition from out-of-state practitioners?

A prime example of a board coalescing three of the above four deficiencies is the Board of Fabric Care licensing dry cleaners. There is a requirement for repeat business assuring competence, a lack of irreparable harm and a system unrelated to competence. Safety problems are treated by Cal-OSHA. So what has the Board done? It has an interesting record. At its inception and for decades thereafter it focused on price fixing attempts, eventually passing a rule requiring misdemeanor prosecution for anyone charging less than \$1 to dryclean a suit (at a time when such a charge was profitable). Over the past decade it has revoked the license of exactly one drycleaner. But it administers a complex entry system. Cleaners are licensed by type, separately for three categories of clothing. The examination has little to do with competent cleaning or pressing and is not taken by those who *do* the cleaning and pressing, but by licensee “owners.” But the Board manages to keep out of the trade the majority of those who seek entry.

#### **B. Ineffective Regulation to Ameliorate Pollution and Hazard External Costs: Standard Setting Gone Wild**

The California Administrative Code is a nightmare of detailed instructions. Boards, commissions and agencies have engaged in rulemaking with little restraint over the past two decades. Boxing promoters are required to file seating charts of the arenas where they hold their matches — repeating charts already on file. Rules concerning ladders at building sites consume over ten pages. Optometrists are now required to know CPR (a rule which interestingly was dropped for physicians by their Board). The consequences of extremely detailed standards are well documented: individualized standards and exceptions often related to the legal resources of the parties involved, gratuitous technology stultification, waste, misallocation, delay.

The agencies of California have not used or even considered seriously non-traditional means to internalize external costs. The Water Resources Control Board, Cal-OSHA covering worker safety, air pollution control agencies, et al., rely on detailed standards and traditional enforcement. The standards not only suffer from the defects we have discussed, but they are not effectively enforced. The tendency is for each of these systems to describe what is now through their standards.

Very few agencies, to the extent they use rulemaking, promulgate generally understood and broad standards related to their mandate and then aggressively follow up with deterrent-producing enforcement. Instead, a “negotiation” pattern is followed. A rule is proposed. A hearing is held. The industry raises problems. Exceptions are drawn to meet those problems. A violation occurs. On the rare occasions where it is detected, the violation is remedied with a warning and request to comply, which, if compliance is difficult, will yield a request to alter the rule accordingly.

The vast majority of standards are only distantly related to a real external harm. Those which are have very little impact on the industry allegedly affected. Of course there are a few exceptions where there has been some impact, but a careful review will reveal that these mostly concern what are actually equipment

standards. These have their own disadvantages, but are enforceable enough to check what otherwise might be a degeneration of an external harm. Auto pollution control, minimum sewage treatment processes and electrostatic scrubbers are examples.

It is a vast oversimplification to conclude that standards by an expert regulatory body should never be used. There are criteria which can justify rulemaking, as we have discussed, especially in combination with other mechanisms where there is irreparable harm without them, as with the regulation of physicians, attorneys, et al. But the brunt of standard setting emanates from agencies which, as we note above, do not need to exist in the first place. Where they do need to exist because of a real and irreparable external cost (e.g., Cal-OSHA, pollution control), the use of incentives which continuously and completely cover external cost production, provide relief for victims and do not misallocate resources, are not considered at the state level.

### **C. Regulatory Charade: Disguised Cartels**

There are numerous areas of business suffering from serious market flaws. Some of these justify regulation at some level. But these justifications are often turned upside down by careless legislation and deferential courts. Two massive examples involve the regulation of agriculture and of alcoholic beverages, respectively.

In the case of agriculture, the external cost underlying initial government entry has largely turned on market volatility. Radical supply fluctuations create serious displacement costs as some farmers lacking a deep pocket to outlast an aberrational year are irretrievably driven out. Government intervenes to facilitate survival of small farmers to preserve vigorous competition and to smooth out violent market fluctuations.

At the federal and state levels, farmers were allowed to collude in the marketing of their products. These lawful cartels have functioned in federal so-called "marketing orders" to do far more than limit external costs. They have affirmatively engaged in price-enhancing traditional cartel practices: setting arbitrary "quality" standards and agreeing to limit the supply of their produce.

At the state level some of the same activity has occurred. Milk regulation historically, for example, has meant the division of milk into "classes" and limitations on the quantity and use of milk by collusive agreement of purported competitors. But most activity through state marketing orders has been to promote their product. There is nothing wrong with any entrepreneur promoting his product. But these entrepreneurs use the power of the state. They are able to coercively levy fees on all who produce a given product. Those who pay the tax are quite willing to do so since it is imposed on all competitors and acts as a tax passed on to consumers.

In California, the most active promoters are the agricultural associations promoting beef, dairy products and avocados. The newest board is one created to promote wine ingestion financed by large scale assessment of California vintners. Where is the external cost being ameliorated? Where is the external benefit being conferred? The power of the state is used to collect monies and organize promotion of beef, milk, cheese, avocados and wine. Is there any indication that the diet of Californians suffers deficiencies in these food categories warranting public involvement in their promotion? One would have to guess that these would probably be about the last foods any competent nutritionist would list in need of promotion, given their current levels of ingestion.

Alcohol regulation is an example of more traditional "licensing" which is not based on a market flaw, but which itself creates an unintended defect. Concerned about the proliferation of bars in San Francisco during rather wild times, the state intervened to "cap" the number of liquor licenses at one per 2,500 population for on-site drinking and one per 2,000 for liquor stores. Limits were set county by county except for those who were licensed when the limits were passed. These people were grandfathered in.

The system is now justified on the same basis as was vertical price fixing in liquor: there is an external cost implicit in the drinking of alcohol. Although land use controls limit the location of the bars and

stores, limiting the number of licensees makes liquor a bit more inaccessible and expensive, discouraging consumption. (The California Supreme Court has rejected a similar argument on behalf of the fixing of resale prices for liquor by the manufacturer.)

The result of this system is the same as with more artificial barriers, e.g., the New Motor Vehicle Board approval system described above. It raises price. But by creating extra profit it attracts investment to the enterprise, enhancing promotion. The value of a license increases over time, a cost which is borne by consumers but not collected by the state. It is collected by the person selling the license. If one wishes to discourage liquor consumption, a laudable goal conferring an indisputable external benefit, simply increase the tax. Use the proceeds to finance alcohol abuse programs, perhaps even alcohol education efforts to counter state-organized wine consumption promotion.

#### **D. Fraudulent Regulation**

Is there another side to the misregulation coin? Are there areas where regulation is warranted, even to the point of comprehensive prior restraint licensing? Of course. We have mentioned medicine and law as two areas where the alternatives at least appear to be unworkable. Where there is such an overwhelming need for competence that we are prepared to violate the basic right of our citizenry to offer their services in the marketplace, we should have a clear reason for doing so. Where we may have such a reason, does it guide our regulatory system? The answer is no.

The two primary examples where the licensing alternative may be justified illustrate the irony of prior restraints. Although we impose licensing on physicians, we confer a single all-purpose license to “practice medicine.” Who “practices medicine?” One may go to an internist, a urologist, a dermatologist, a neuro-surgeon. One must have a competent *urologist* if one needs kidney treatment.

There is a connection between a competent urologist and the general state license, but it is very indirect. Certainly, the licensure barrier keeps out those who are of particularly low general aptitude, although certifying medical schools appears to do that. But there is no significant testing of any physician even *measuring* to any relevant degree special competence in the area where he or she will be spending the rest of a professional life. As far as the *state* is concerned, a urologist can perform brain surgery. Perhaps malpractice fears (a rule of liability) or insurance requirements or private (e.g., hospital or private trade association) certification help limit such wandering, but these controls are unrelated to licensing.

Although the medical barriers to entry are severe in difficulty, and only distantly related to actual competence as a physician practices, there is little attention given to ensuring the competence of those who have made the club. Malpractice judgments are not even systematically reviewed.

Unsurprisingly, very few physicians of any description have their licenses revoked for anything short of felony drug or rape offenses.

Although the maintenance of competence in medical specialties requires constant re-education, there is no continuing education requirement. There is no re-testing at any point. (Note that nurses are, in contrast, required to submit to continuing education.)

Virtually an identical critique could be applied to the regulation of attorneys. No attorney practices immigration law, estate planning, criminal defense, patent law, tax law, divorce law and antitrust law. Attorneys may practice in more than one area competently, but no attorney can practice competently in a substantial number of the twenty-odd specialties which have evolved. As far as the state is concerned, they are perfectly free to do so. A patent attorney can defend a capital murder case.

The consumer expects that the onerous prior restraint of licensing assures counsel competent in the area where there is a problem needing services. The state does not do that. As with medicine, the Bar tests

graduates on general principles unrelated to particular knowledge in most areas of actual practice. It is true that persons with an ability to answer Bar questions will, in a very general sense, be somewhat more likely to gain competence in a given area of practice. What the state really tests is general aptitude, not relevant competence. A simple alternative to the massive regulatory systems in place: the required disclosure of schools, degrees and grades of physicians and attorneys (based on hundreds of examinations) provides a far better measure of such aptitude and some information about expertise.

As with medical regulation, the Bar does not require specialized competence of any kind, continuing education of any variety or re-testing. And its record of policing incompetence from within the existing profession is virtually non-existent. In California, for example, approximately 25 attorneys have their licenses revoked annually out of over 90,000 members of the Bar. Most of these have their licenses restored in short order. Once again, felony offenses against their own client is the basis of most of the revocation activity, such as it is—although one attorney was recently sanctioned for writing undignified remarks about a judge in an appellate brief.

If state determination of the right to do business is justified, given the extraordinary cost in the sacrifice of a basic freedom, it must occur only because of an extraordinary need for competence to avoid irreparable harm. Such a need means that the system must provide what its justification demands. This can be expected to mean not just a scorpion's club initiation ritual (scorpions are said to form a ring when attacked, like a besieged wagon train, each facing their sting-inducing tail outward toward the intruder). Justification demands proof of competence in the specific areas of practice where reliance occurs, continuing education, periodic testing and the assiduous removal of those who do not maintain their skills.

The message conveyed here can be summarized: use prior restraints only for good and unavoidable reason—but if the reason is there, fashion the system to it in a bona fide fashion. If competent practitioners are critical then by God assure competent practitioners in the areas where they practice and are relied upon.

It is ironic that in the several areas where such prior restraints may be warranted, they are not applied in good faith.

## **VII. HOW TO REGULATE**

Assuming a good faith basis for a regulatory system, particularly one appropriate for a licensing format, how should it be accomplished? How should it be monitored? What ancillary remedies (in addition to licensing powers) may be appropriate? Our watchword in analyzing structure, authority and standards is to preserve the basic check in the American system: the independence of the state. These systems exist because the marketplace is flawed. Its restoration or substitution must be entrusted to those who can represent the interests of the general citizenry in whose interests the intervention occurs.

### **A. Structure**

#### **1. Level of Regulation**

State regulation may not be viable where it unduly burdens interstate commerce, or state systems imposed with variations between states affects a highly mobile regulated group. Only a national or international system can prevent jurisdictions from being played off against each other, to gravitate toward the lowest common denominator. E.g., so long as Delaware offers minimal standards for incorporation, to what degree can individual states require more? Perhaps they should not require more, but the false competition for revenue between states is not conducive to a common rule which might ameliorate a market flaw. To impose such a curative rule it must be adopted at a level where it can be effective and cannot be avoided easily.

An Athletic Commission regulating boxing cannot reasonably function where it depends for revenues on gate tax receipts from high attraction matches and promoters can schedule events in any one of fifty different states. Promoters simply avoid the gate taxes, boxer pension systems, or safety-orientated regulations of any given state by seeking the state with the lowest regulatory standard.

Most regulation, however, does not unduly burden interstate commerce and does not involve a highly mobile licensee group. Regulation may involve legitimate differences between the cultures and peoples of the various states. Most regulation may be expected to occur at the state level.

Regulation at the local level may suffer from the same kind of destructive competition *vis-a-vis* the state that state regulation may suffer *vis-a-vis* the federal government. Except such destructive competition is much more likely given the relative mobility of practitioners in commerce within given states. Furthermore, although the nation has a tradition of direct local democracy, in fact, the reality of local government is quite different.

Local governments have been so fragmented by geography, function, and type, that direct democratic response is limited. Although there are equivalent problems at the state level with regard to gerrymandering, campaign contribution influence and other forms of abuse, at the local level these forms of abuse are supplemented by the relative invisibility of local officials. Los Angeles County, for example, includes 342 special districts. Each one of these districts performs a very fundamental and important governmental task. Special district governance at the local level accomplishes everything from mosquito abatement to parks, education, provision of water and other essential functions.

California has 5,000 special districts, 480 cities, and 58 counties. The special district, city and county lines do not follow rational boundaries. Drawing all of the governmental bodies within one urban county on paper would scarcely leave an unlined area. The shapes of the districts are not compact. Cities often run in corridors one hundred yards wide by ten miles long in order to capture a piece of tax-valuable property at the end. The governments of special districts are sometimes elected, and often appointed. The precise boundaries between cities and counties often go down the middle of the street, sometimes to one side, sometimes to the other.

Surveys of citizen awareness of fundamental local government functions has revealed responses concerning who provides basic water, trash, police and fire services approximating what one would expect with a roll of the dice: random guesses. Although local regulation may be advisable in a system where there is a multi-purpose government visibly governing a recognizable and compactly shaped area, that is not what we currently have. Local government, in the area of land use, "exclusive franchises," the letting out of preferential contracts, et al. manifests the most egregious abuse of any level of government.

Any system of local regulation depositing in the hands of local officials the authority to decide who should or should not practice a trade, who should or should not have a monopoly in a given enterprise, et al., should be accompanied by a state authorizing statute designed to systemically preclude abuses. The statute must specify the restraints of trade to be allowed, and provide for required checks to compensate for the absent marketplace. This minimal requirement is presumably the law of the land. The United States Supreme Court has declared the "state" to be the antitrust gatekeeper. Before a regulatory restraint of trade can contravene the federal antitrust statutes, the state must fulfill its obligations as sovereign. It must specifically authorize any restraint and provide for "independent state supervision," it cannot deliver a "blank check" to local government.

Examples of abuse proliferate. The starkest is in the area of trash hauling, where a trade association was able to obtain such a blank check for commercial trash hauling, normally subject to competition. The state law simply declared any arrangement approved by any of the 5,000 special districts, 480 cities, and 58 counties immune from antitrust exposure. The law issued such a blank check that monopolies without any

possible competition or required rate regulation and lacking even competitive bidding were permitted. Local officials in the fragmented setting of local government could allow only one trash hauler into their jurisdiction to service businesses, apartments and construction sites, and make that monopoly grant worth millions of dollars. The largest firm dominating this industry is now successfully obtaining “exclusive franchises” (monopolies) throughout the state. Such an abdication by the state creates an atmosphere ripe for corruption as well as the violation of the most elementary principles of regulatory law.

## **B. Who Should Regulate**

In most states, regulatory agencies consist of the trade, profession, or industry regulated. Such a system contravenes fundamental constitutional principles. We live in a system where the most fundamental civics concept commands that our government, the “state,” represent the people. The state does not represent economic interests with a narrow profit stake in public policy, it represents the general public; the diffuse interests of all of us as citizens. It represents our concerns for the environment, the future and ourselves as a whole. We do not require governmental intervention if all it does is to replicate the functions of a private cartel.

Those persons making decisions on behalf of the public, precisely because the public has an interest separate and apart from the entities of profit stake interests, must have only the public at heart. It should be a fundamental axiom of American government that those regulatory bodies making decisions on behalf of all of us, and invoking the awesome power of the state, must not consist of those with a proprietary profit stake in the public policies being formulated. Yet in California and in almost every state to yet a greater degree, such is the case. By direct operation of law a majority of members of the Board of Medical Quality Assurance in California consists of physicians. The majority of the members of the Board of Accountancy consists of accountants. Even those boards which include “public” members count among them persons (for most agencies they constitute a voting majority of a quorum) with a direct profit stake in the public policies being formulated.

It is one thing for profit-stake interests to form trade associations to provide information, advice and opinion to government decision makers. It is quite another thing for them to be the government decision makers. Such a pattern transgresses fundamental notions of due process and cannot be tolerated in a constitutional democracy.

What is perhaps most interesting about current state regulation throughout the nation is the likely wholesale contravention of federal antitrust and Constitutional principles by these systems. The United States Supreme Court threw out the attempt by the Alabama Board of Optometrists to sanction an optometrist (*Gibson v. Berryhill*). The court held it violated fundamental notions of due process to have state officials with adjudicatory powers currently competing, however indirectly, with an object of Board enforcement. Most recently, California courts have tentatively voided part of the New Motor Vehicle Board Act because three of the Board’s seven members are auto dealers and are therefore institutionally biased. An appellate court has found that their very presence on the Board taints it. Meanwhile, federal courts are requiring state agencies which restrain trade to be immunized from federal antitrust exposure only if the state provides *independent* state supervision, i.e., supervision by state officials unconnected to those with a proprietary stake in the policies being formulated.

These precedents, if consistently and properly applied, void most of the current state regulatory systems in all fifty states—and they do so quite rightfully.

## **C. Funding**

Almost all regulatory agencies are “special funded.” That is, the industry or trade regulated is assessed charges which go into a separate fund financing the budget of the public agency regulating it. On the surface, an industry or trade producing an external cost should not only have that cost internalized if

possible, but the cost of doing that internalization should also be internalized. However, the direct tie between fees and budget is improper. The legislature should first decide how an industry's or trade's market flaws should be addressed, determine the amount of money necessary to accomplish that end, and then and only then attempt to assess that industry or trade an amount not too different from that cost.

There are circumstances where such assessments may not be realistic. The Athletic Commission, for example, gains monies from gate tax receipts. Only "big" matches produce significant revenue, but promoters will take those matches out of California to avoid taxes. Where the external benefits of a regulatory system extend to society at large or where destructive interstate competition precludes collection, some contributions from the general fund may be warranted.

The other side of the same issue is the tendency of the legislature to see all special funding as free. A hidden tax without political resistance is considered no tax at all. Hence, any suggestion by a trade or commercial association to set up a licensing system funded by themselves is viewed as a proposal without political liability.

All monies collected from regulatory fees should go directly into the general fund. Budgets should be drawn from the general fund based on the public interest in the expenditures to be made. Then the legislature's finance committees should periodically adjust fees to approximate the money being spent where appropriate, which will usually be the case. The effect of this procedural change is to focus legislative attention on these budgets as public expenditures—which is what they are. They should compete for priority. And agencies should not be in the conflicting position of having to approve an unwise but revenue-producing boxing match or another remunerative examination entry barrier in order to add new equipment or more secretaries for their own shop. Nor should agencies be compelled to eschew removing the incompetent because of budget constraints. The revocation of a license is an expensive proposition. Currently, agencies pay for their own counsel, an administrative law judge and court reporter. For small agencies, the costs are formidable. And they are a very real bar to aggressive internal "clean ups" in the rare cases where the spirit is willing. Where budgets depend upon after-the-fact increased license renewal fees from those currently licensed, the prospects of major increases supported by a trade to finance internal policing are not sanguine.

The funding of such regulatory bodies is one of the few areas where Parkinson's Law that expenditures rise to meet income should be reversed, income should rise, after the fact, to meet expenditures. This is a very bad idea in public works and benefits budgeting, of course, but not in the financing of regulatory system mechanisms.

#### **D. Bifurcation of Executive/Adjudicative**

Regulatory agencies are very special legal creatures. They are given a very general mandate by the legislative branch to address a social purpose — often defined in a single clause. For example, the Federal Trade Commission is empowered to deal with undefined "deceptive advertising" and vaguely defined "unfair acts in competition." Agencies perform a major quasi-legislative role to fill in detailed meaning consonant with their authorizing statute's intent. Agencies "adopt rules." And they adopt thousands of them. State Administrative Codes now rival in extent and certainly surpass in detail the whole body of annually enacted statutes by state legislative bodies.

Rulemaking establishes standards of behavior which are often intended to give predictability and warning to agency action. Where there is a violation of a rule, the remedial powers of the agency may be invoked, powers which vary from the entry of an order to halt a given practice, to revocation of one's license to do business.

In enforcing its rules, the agency performs an executive function. It detects violations. It establishes enforcement priorities. It prosecutes the case. There is no conflict between the rulemaking and enforcement

roles. But the regulatory body often fulfills yet a third role, a judicial one. For having decided to prosecute a violation of its statute or rules, it also establishes the procedures for “hearings” on the charges. And it even serves as judge. It may make findings of fact.

The dual prosecutorial/adjudicatory role is a troubling one in a common law adversarial system. Certainly state Administrative Procedure Acts provide due process protection. And there is court review. But the fact remains that the entity who made the rule and who decided to prosecute is also sitting as judge. And court review is a very limited check given the deference paid to procedurally proper agency adjudications.

There are several ways to cure this imbalance. One is to use the Office of Attorney General or some other independent office as prosecutor. Staff simply turns over information concerning compliance to a separate entity with its own discretion to prosecute or not to prosecute. Another alternative for larger agencies is to restructure the agency as Commissioner Phil Elman has suggested for the FTC and as the California PUC has done: to bifurcate the agency staff. Those who perform as prosecutors or advocates are separated out into their own department with separate lines of authority from the “Commission” and its adjudicatory staff.

A more radical alternative would give a separate “Department of Consumer Affairs,” which most states already have created, power to conduct investigations of violations and to prosecute them before the agency.

### **E. Representation of Diffuse Interests**

Regardless of the reforms undertaken, regulatory agencies are bound to reflect “intensity of interest.” That is, those with their won stake in agency policy will turn their attention to its influence. Even neutral board members will be subject to the regulatory environment described below. Trade association advocacy can be expected.

But since the agency exists to counter market flaws, it is critical that information and advocacy not be dominated by those whose interests often represent the very abuses the system was established to prevent or minimize. Several structural adjustments can facilitate a balanced consideration of the more diffuse interests which are otherwise underrepresented.

The first measure is the creation of an adequate and structurally independent staff. The “deferred bribe” of agency apprenticeship followed by trade employment must be precluded by terms of employment which prohibit employment with the trade regulated for at least several years after leaving the agency.

The second structural reform is the stimulation of those diffuse interests affected by an agency’s actions to organize and represent themselves to counter the automatically organized profit stake interests. An agency, of course, should comply with the “sunshine” “standards of operation” discussed below. But beyond this, an agency can implement generous standing requirements to appear before it and argue, particularly in the rulemaking area. Proposals for de novo rulemaking should be entertained without standing impediments.

Some agencies can go much further to allow diffuse interests to have a role. The California PUC has allowed the Utility Consumers Action Network (UCAN) to gain access to the bills of the local utility. The bills mailed out to ratepayers have always been financed as an expense item off the top by the ratepayers. The proponent for access proved there was “dead” or unused space in the envelopes requiring no additional postage. UCAN communicated with ratepayers, solicited funds, conducted elections. Over 75,000 ratepayers have joined the organization. The voting percentage of electors in the election of the Board of Directors was double that of the municipal elections. The organization is now funding professional and organized advocacy before the PUC. This organization has democratically institutionalized advocacy of an otherwise underrepresented group. It cost the taxpayers nothing. It cost the ratepayers nothing. The regulator simply



used an available asset to facilitate more balanced advocacy before it. The requirements in the proposal for fair elections are of special import. They assure that the advocate is a legitimate representative of the interests it purports to represent and they remove any taint that the regulator may be favoring any particular consumer group in allowing access.

Related to the UCAN reform is intervenor funding, allowing those who are able to represent diffuse interests and who benefit the regulatory process, to recover costs and fees. The California PUC has laudably adopted such a procedure.

Another structural feature which can address the profit stake vs. diffuse interest imbalance problem is a general Office of Consumer Advocacy, either within an agency or within the larger administration. Such an office can professionally represent diffuse interests where they are not capable of organization.

## **F. Proper Authority**

Assuming a structure amenable to regulatory policy in the public interest, how should the authorizing statute be framed?

### **1. Statutory or constitutional**

The first question is where should it exist, in the State Constitution or in statutory law? The answer is in statutory law. States nevertheless are persuaded by interest groups to put enabling provisions straight in the most fundamental document underlying our state. In California, our sacred guarantees of free speech and religion adjoin provisions creating a Board of Chiropractic Examiners, a Horse Racing Board, an Athletic Commission, a Board of Osteopathic Examiners, the State Bar and the Public Utilities Commission. One of the effects of such folly is the creation of regulatory arrogance. The State Bar contends that it is exempt from the open meetings and public records sunshine laws of the state. The Board of Osteopathic Examiners refused to seat two public members appointed by the Governor, contending that it did not have to obey a statute adding two public members to its Board since it was “created in the State Constitution.” The Athletic Commission notes that it does not have to comply with the Administrative Procedure Act.

If one were to create an exalted class of platonic regulators, this is not the crew one would assemble. There is no need to put any regulatory system designed to address a market flaw in so basic a document as a Constitution.

### **2. Specificity**

The second feature of the authorizing statute, apart from its creation of *only* public members to make decisions on behalf of the public, is specificity. The means assigned to compensate for a marketplace flaw must be set forth. If one allows a created board to “license” methodone clinics, does that mean it can specify how many staff must be on premises? How many medically qualified patients a clinic may treat? What prices may be charged?

The law must allow for flexible response, but within some range of specified options.

### **3. Remedies**

Confer remedies to address effectively the market flaw. The Federal Trade Commission is given the task of policing deceptive advertising, a task impossible without deterrent punch. Its major remedy is the right to issue a complaint and establish a “cease and desist order.” This order takes, on the average, 4.17 years to establish where it is contested. There is no prohibition on advertising and no sanction of any kind unless that cease and desist order is violated (or a similar one you have been served with). Since that will not

happen for 4.17 years, what is the message conveyed? Is it, do not deceptively advertise or we shall sanction you more than you would gain? No. The message is: do whatever you want. We guarantee that we shall do nothing to you for four years or more. Only after we get our cease and desist order in place are penalties possible. So our remedy is actually a license to deceive — a grant of immunity.

By the same token, it is a mistake to confer only a single extreme remedy. Boards such as the California Contractors State License Board had only the draconian power to suspend or revoke licenses for many years. It could not fine. There was no gradient of sanctions consistent with the spectrum of wrongs it can be expected to address. Faced with depriving someone of his livelihood or doing nothing, it usually did nothing. Several years ago it was belatedly given the power to fine.

#### 4. Who is regulated

The authorizing statute should define precisely what functions require licensure. The devolution of jurisdictional authority to the agency itself under a vague mandate leads toward excessive regulation. There is a marked tendency for boards and commissions to impose “prior restraint” licensing not only on the fundamental profession or trade capable of alleged irreparable harm, but directly to the ancillary services tangential to the enterprise. Hence, instead of licensing dentists and holding them responsible for their employees, the Board chose to directly license those employees, now under the appellation “dental auxiliaries.” Real estate brokers are responsible for any transaction conducted under a broker’s license and are fully responsible for the actions undertaken with apparent authority by salespersons working under the “license” of that broker. Nevertheless, the Real Estate Commissioner is licensing all salespersons, several hundred thousand of them. The Athletic Commission, as we have noted, is an extreme example. Although boxing promoters are fully responsible for their events, the Commission has licensed almost everyone they employ, from announcer to ushers, to even the ticket printers.

Some of these paternalistic expansions have occurred by the legislative direction, almost always at the behest of the trade involved. Others have been accomplished by the board or commission operating under an excessively vague statutory charter.

Often the motivation for such expansion is the creation of a “client” group of employees by the prime trade under regulation. Required apprenticeship as a part of licensure qualification can be a cheap source of labor while the apprenticeship is underway. Those who presently practice the ancillary function may support it because they will likely be grandfathered in and the licensing requirements serve as a barrier to entry increasing the long term value of their position. Well intentioned regulators can be persuaded to endorse expansion by a few egregious cases of abuse by these subordinates, and by a natural desire to territorially expand—often for the most beneficent of reasons.

Authorizing statutes should confine prior restraints as narrowly as possible. If there is one trade or profession whose members control an operation, those who are hired by that person, who have their work reviewed necessarily by him or her, need not be separately licensed except in the most extraordinary circumstances. The real estate broker, dentist, physician, etc. is well able to perform a far superior screening function than the mass testing process of standard licensing. Here is the person who reviews background and qualification carefully and individually because he or she is responsible and has both insurance and licensing on the line. The employee must work directly with the prime licensee day by day. A failure to review, an incompetent choice, and resulting harm to those protected by the regulatory system, can give rise to strong sanctions against the persons who are in the best position to hire, supervise the work, judge competency. Such a system avoids prior restraints while making responsible persons far more able to make these decisions than any single testing procedure. License dentists, doctors, brokers, boxing promoters, contractors, and hold them absolutely responsible for persons operating under their respective licenses as employees or subordinate contractors.

## G. Standards of Operation

There are too many operational issues for comprehensive treatment in this forum. But two intra-agency issues belong in any discussion of reform.

### 1. Sunshine

Agencies have an obligation to operate publicly. The sunshine laws of most states which require open meetings and public records are sometimes avoided not only by those agencies with Constitutional identity, but by others subject to the law. To comply with the spirit as well as the letter of the law, members of small boards should not associate socially, the materials used by Board members at meetings should be available to the audience since meetings are incomprehensible without these materials, and document reproduction costs should be reasonable. It is remarkable how much mundane restrictions can bar public access.

### 2. Entry barriers

Entry barriers are the single most troublesome agency operation. Barriers should be imposed fairly and in a timely fashion. For example, a student attends a law school, an institution the Bar declares is acceptable to it, where a degree is a qualification to take the Bar examination. This institution takes \$6,000 to \$8,000 of hard-earned money. And it takes one year of his life. The student succeeds, passes basic courses and is promoted to a second year. The same thing occurs. Then into the third year. The student has expended three years of his life, over \$20,000 in tuition and many more thousands in lost wages and opportunities elsewhere. But he or she is given a Juris Doctor degree. The university certifies the graduate as qualified not only to practice (which is presumably why people go to law school), but to hold a doctorate degree. Then the Bar flunks a large portion of those people. In California, the majority of those taking the exam are flunked. For some of the twice-yearly exams, the passage rate has been below 40%. For many of the law schools the passage rate is below 20%, for some consistently below 15%. Is something wrong here? To be sure, we inveigh against the state depriving anyone of an opportunity without good reason. But if we have a good reason to limit entry, is there any reason we lead so many down the primrose path for so long? If we're going to say no, why not say no a little earlier on? Why should the Bar preside over the gratuitous tragedy of so many? Why are schools certified which achieve less than 50% passage rates, much less 20%?

To be fair, entry barriers should relate to the kind of competence consumers will be relying upon. They should not be exercises in raising the drawbridge. Is it really necessary for an architect to know about the contents of an Egyptian tomb?

It is amusing to hear some laud the United States Marines who saved the medical students studying in Granada. We hailed as heroes the protectors of those important Americans. Did we do them a favor in allowing them to continue their studies? How many are going to achieve entry into the profession they were there to seek? They will be saved and brought home to White House gatherings, after which state medical regulators will attempt, with predictable success, to bar their entry into the profession.

The entry process itself should somehow measure the skills and information needed to perform. Few entry systems short of apprenticeships assure much more than a commitment to the enterprise and general aptitude.

Perhaps one of the more fascinating examples of entry irrelevance is the real estate sales and brokers exam. This is a multiple choice question examination. The difficulty and ambiguity of a multiple choice question is well known. And the questions are excellent. In fact, there are very few brokers who know the answers to them. The exam is honed by a process of reverse natural selection. Any question successfully answered by a majority of the examinees is dropped and a new one added. One can imagine the breed of

those which remain, year after year. So how does one pass? A series of schools send in spies who memorize questions and answers and put together actual test questions and answers from exams going back three or four years. Most of these questions will be on the next exam. They are memorized. The critical barrier to entry is an ability to memorize and a willingness to pay one of the schools their substantial fee. The fee is a barrier to entry, which the state general fund could perhaps better use.

## **VIII. REGULATORY OVERSIGHT: THE ENVIRONMENT**

Regulation exists in a political environment. These are public agencies. They must go to the Governor's Department of Finance for budget approval. They must submit to scrutiny by the legislature. They must deal with the general auditing and review agencies under the legislature and the Governor.

### **A. Horizontalization**

The politics of regulation fully reflect what a sociologist might call the "horizontalization" of our society. We are less a nation of owner-operators than ever before. We are increasingly a nation of employees. We are organized around our peer groups. We identify with our peers. The prosecution of hospital kickback schemes by this author illustrated not only the well-documented vertical alienation between the hospital administrator and patient - but the concern of the administrator over what peer administrators in competing institutions are thinking and doing.

Politically, the horizontalization can be seen in burgeoning trade associations, thousands of them in Washington, D.C., and hundreds in most major state capitols. The massive, modern buildings housing the National Coal Institute, American Petroleum Institute or the American Association of Railroads would not be mistaken for the site of a PTA meeting.

Although we have described the counter measures which can be taken to preserve some balanced advocacy before agencies, the campaign contribution and advocacy imbalance between profit stake interests and the general public interest is more serious in the surrounding legislative environment. On the positive side, the somewhat higher visibility of the legislature and possible contention between a greater mix of interest groups does create opportunities. One might build a coalition of interest groups who are not directly involved themselves in a given issue. If they can be persuaded to participate, they may represent a broader interest than the legislature would otherwise hear from, on issues apart from their primary concern.

However, there are structural and practical obstacles to an independent legislature. At a practical level most states lack even a critical mass of public interest private advocates to build a coalition. One study of land use policies in California surveyed lobbyists before the state legislature. There were 235 representing various profit stake interests. Two represented the general public, the taxpayer, the environment, the consumer, the future. And where an agent for coalition building appears, it is often difficult to persuade a narrower lobby to expend political capital on behalf of a cause outside the narrow mandate of the sponsoring association.

### **B. Campaign Finance**

The direct corruption of campaign contribution influence is more lethal to the integrity of the state than is advocacy imbalance. The impact of more expensive campaigns and trade association contribution dependence has so undermined the independence of the state that the most basic check in the American system is in jeopardy. The solution may be politically difficult without major citizen upheaval. Only the public financing of campaigns, with fair rules for competitors, can remove what is now, at the risk of perceived hyperbole, nothing less than a dagger plunged into America's breast.

California has its quota of Lloyd Connellys, legislators who are willing to do the hard work to pierce into state government on behalf of broader interests. It is important that public financing occur to create

more of them and to free those extant from the burden and shame of begging, however dignified it may appear. Contributions, even among the most ethical of legislators, buys at least access. Given time constraints on legislators, that is no small compromising commodity.

### C. Oversight

What the regulatory environment needs is independent legislators with time and staff to oversee as well as to service. Rather than the benign nonfeasance of agency attention to keep it out of the general fund or to please a vocal constituent, there should be a schedule of oversight hearings. Each agency should have to expect a tough set of hearings at least once every three years on its performance in what will be a relatively more public forum than the agency's own environment creates. At present, it must account to very few indeed.

### D. A Bold Reform: An Office of Administrative Law

One of the major oversight reforms attempted by the legislature created an Office of Administrative Law. This was a bona fide attempt by the legislature to clean up what it believed to be excessive and nonsensical rules by the state regulatory system. Recognizing its inability to oversee with the kind of detail needed to have a real impact on the many agencies, it created an executive branch entity to complete the task. As an experiment in regulatory reform, it was imaginative and bold. And it has achieved some successes. After four years of operation it is now possible to gauge more clearly what such a body can and cannot do responsibly.

The Office of Administrative Law was given the power to review existing rules and to approve new rules as they are adopted. OAL consists of a staff of some twenty young attorneys. They are empowered to use six criteria in reviewing a rule: reference, non-duplication, consistency, clarity, authority and necessity.

One can see the impact such a review may have on rulemaking. For example, conservative scholars have quite rightly critiqued many of these agencies for *ultra vires* rulemaking beyond any legislative mandate. Although there is a basis for legal challenge where an agency acts without authority, who is to sally forth with the challenge where the licensees enjoy a cartel benefit from the rule? In fact, well under 1% of all rules are challenged in court at all. This Office will now review each and every rule for proper authority. That is a momentous change.

Two problems exist which independently threaten this generally thoughtful idea - each will create a monster far worse than any abuse addressed by the new law. First, the sixth criteria, "necessity," is inappropriate for review by the Office. Whether a rule is "necessary" is a shorthand way of saying "sensible," "advisable," "a good idea." But the twenty attorneys who sit in the Office of Administrative Law have no knowledge of the substance of the regulation they are reviewing. They do not attend hearings. All they have before them is a file summarizing public comments and the agency's response.

It is possible that an Office of this kind can perform an academic "legal" review of rules. It can evaluate the statutory authority. It can address the clarity of the rule. It can survey for duplication and consistency. But to give it the authority to reject rules because of its perception that they are not "necessary" is a task which cannot be responsibly performed by them. This inability to second guess in ignorance is one of the reasons courts are not allowed to overturn normally the findings of the trier of fact. Courts, as outside parties not present at the hearings, will examine proper authority and may critique in dicta lack of clarity. But they generally will not intrude into the expertise or fact finding of an agency. And they hesitate for good policy reasons.

Theoretically, the Office could argue that it merely examines the rulemaking file to make sure that there is some factual basis for a rule. But what does this mean? Does it mean there must be some words of

justification placed after each clause in a rule? Does it matter what the words say? If it does not matter it is a futile exercise. If it does matter, who is judging whether the words provide justification such that the rule is “necessary” or “a good idea?” How is it making that judgement?

The eventual result of this process is two-fold. First will be the rejection of many rules which are quite necessary because of a technical failure to include a factual justification for a provision nobody contests. The second is the advent of gamesmanship. The agencies learn what words to use to justify what they want to do. Since the Office of Administrative Law lacks any expertise whatever in the area, since the process is not adversarial and the agency can provide whatever it wishes and since factual justifications exist for everything from nuclear war (population control) to banning rock and roll music (damage to the inner ear), a great deal of impressive-looking paperwork will be produced.

Both consequences are now occurring with a vengeance, and the net result is, as the cynics would have predicted, far more red tape and regulatory delay than would now be the case without the reform.

The second flaw is the allowance of ex parte contacts between private parties and the Office of Administrative Law. The Office can and will become a conduit for improper reversal of rules by those who lost in the public forum but who now can meet secretly with officials from this Office and lodge complaints properly rejected or never made in the public forum. The Office in California has not only allowed such improper contacts, it has at least historically encouraged them.

The Office of Administrative Law idea is a reform of some promise if properly harnessed, and of great danger if not itself reformed.

## IX. CONCLUSION

A first imperative is to articulate a defensible theory on which to base a regulatory system. The state must identify the flaw to be addressed, and specify a means of amelioration precisely addressing it.

We have created some 60 regulatory agencies in California. They operate largely invisibly, with little legislative or public scrutiny. Many operate where there is no significant market flaw to address or consumer benefit resulting. We have expanded existing regulatory agencies into areas where they have no business. Where we have regulatory agencies with a legitimate purpose and a real market flaw to address, we have avoided that task in favor of cartel practices. And we have the system dominated by those with a narrow profit stake in the public policies they are adopting and imposing on all of us with the force of the law and in the name of the state.

While creating paternalistic rules and raising barriers to entry, few of the boards or commissions in the State of California, even those covering professions which create irreparable harm and whose regulation can be justified, have attempted to remove those currently practicing who are incompetent and who create that irreparable harm.

And the agencies continue to expand and new ones to proliferate. More and more trades and businesses are falling under the rule of “prior restraint.” Alternatives are unexamined. We can be a psychologist when and if the state tells us we can, and what is worse, the Committee deciding consists largely of psychologists.

The Soviet system is comprehensive in its stultification. There, prior restraint does not require market flaw justification. It is presumed. And the system has the one failure which has long been anathema to the American experiment: a lack of checks and balances. In socialism there is no check between the state and the means of production. The state owns and operates the means of production. There is one system evolving here which is perhaps worse, and just an inimical to American principles; a system where that check is also obviated, except the means of production own and operate the state.

**A Theory of Regulation: A Platform for State Regulatory Reform**  
**By Robert C. Fellmeth**  
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**Chart A**

<u><b>Flaw</b></u>	<u><b>Societal Response</b></u>
I. Natural Monopoly	1. Structural Change to Restore Market 2. Maximum Rate Regulation/Management 3. Government Ownership
II. Scarcity	1. Market Sale 2. Qualification 3. First Come 4. Line
III. Adhesion/Imperfect Information	1. Structural Change 2. Consumer Education 3. Disclosure Requirements with Nonmechanical Remedy 4. Certification by the State 5. Regulation by Permit with Rulemaking
IV. External Costs	
A. Damages	1. Internalize through Required Tie-In 2. Internalize by Tax Transfer 3. Internalize by Marketing Rights Sale 4. Equipment Standards 5. Harm or Output Standards 6. Internalize by Judicial Assessment by: <ul style="list-style-type: none"> <li>a. Rule of Liability</li> <li>b. Procedural Reform</li> </ul>
B. Damages with Possible Inability to Assess/Collect	1. Bonding/Insurance Requirement 2. Preliminary Relief
C. Damages with Health and Safety Irreparable Harm	1. Mechanical Tie-In by Statute 2. Straight Civil Prohibition with Preliminary Relief 3. Public Prosecution (Civil/Criminal) 4. License Revocation

**Chart B**

**California Flaws**

List of Agencies	1	2	3	4	5	6	7	8	9	10	11	12
Board of Accountancy	?		✓	✓	✓	✓	✓	✓	?	✓		
Board of Architectural Examiners		✓	✓	✓	✓	✓	✓	✓	✓	✓		
Athletic Commission		✓			✓			✓	?		✓	✓
Bureau of Automotive Repair					✓	✓	✓	✓		✓		
Board of Barber Examiners	✓		✓	✓	✓	✓			✓			
Board of Behavioral Science Examiners	✓	✓	✓	✓	✓	✓	✓	✓	✓			
Cemetery Board				✓	✓	✓	?	?	?	✓		
Bureau of Collection and Investigative Services		?				✓	✓	?		✓		
Contractors State License Board		✓	?		✓	✓	?	✓	✓	✓		
Board of Cosmetology	✓	✓	✓	✓	✓	✓			✓			
Board of Dental Examiners		✓	✓	✓	✓		?	✓	✓	✓		
Bureau of Electronic and Appliance Repair	✓	?				✓	✓	?				
Board of Fabric Care	✓	✓	✓	✓	✓	✓	✓	✓	✓			
Board of Funeral Directors and Embalmers		✓	✓	✓	✓	✓			?	?		
Board of Registration for Geologists and Geophysicists	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓		
Board of Guide Dogs for the Blind						✓		✓				
Bureau of Home Furnishings	✓	✓	✓			✓	✓	✓	✓			
Board of Landscape Architects	✓	✓	✓	✓	✓	✓	✓	✓		?		
Board of Medical Quality Assurance			✓	✓	✓			✓		✓		
Acupuncture Examining Committee			✓	✓	✓			✓		✓		
Hearing Aid Dispensers Examining Committee	✓		✓	✓	✓	✓		✓				
Physical Therapy Examining Committee		?	✓	✓	✓			✓	✓	?		
Physician's Assistants Examining Committee		✓	✓	?	✓	?	?	✓	?			
Podiatry Examining Committee		?	✓	✓	✓			✓	?			
Psychology Examining Committee	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓		
Speech Pathology and Audiology Examining Committee		✓	✓	✓	✓	?			?			
Board of Examiners of Nursing Home Administrators		?	?	✓	✓	?	?	✓	?	✓		
Board of Optometry		?	✓	✓	✓	?			?			
Bureau of Personnel Services				?	✓	✓	?	✓				
Board of Pharmacy			✓	✓	✓			✓		✓		
Board of Registration for Professional Engineers and Land Surveyors	✓	✓	✓	✓	✓	✓	✓	✓	?	✓		
Board of Registered Nursing		?	?	✓	✓			✓	?	✓		
Board of Certified Shorthand Reporters	✓	?	✓	✓	✓	✓				?		
Structural Pest Control Board		✓	✓	✓	✓	?						
Tax Preparer Program			?	?	✓	✓	?	✓		✓		
Board of Examiners in Veterinary Medicine		✓	✓	✓	✓	?		✓	✓	✓		
Board of Vocational Nurse & Psychiatric Technician Examiners			?	✓	✓	✓		✓	✓	?		
Department of Alcoholic Beverage Control	✓	✓	✓			✓	?		✓	?		
Banking Department		✓	✓		✓			✓		✓	✓	
Department of Corporations		?			?		✓	✓		✓	✓	
Department of Insurance		✓	✓		✓			✓	?	✓	✓	
Department of Real Estate		✓	✓	✓	✓	?		✓	✓	✓		



**Chart B (cont'd)**

**California Flaws**

<b>List of Agencies</b>	1	2	3	4	5	6	7	8	9	10	11	12
Department of Savings and Loan		✓	✓		✓			?	?	✓	✓	
Cal-OSHA		✓				✓	✓	✓		✓	✓	
Department of Food and Agriculture		✓		✓	✓	✓		✓	✓			
Office of Statewide Health Planning and Development		✓			?	✓		✓	✓			
Air Resources Board		✓				✓	✓	✓		✓	✓	
California Waste Management Board						?	✓	✓		✓		
Coastal Commission		✓				?	✓	✓		?		
Department of Fish and Game					?		✓			✓		
Board of Forestry		✓	?			?	?	✓		✓	✓	
Water Resources Control Board		✓				✓	✓	✓		✓	✓	
Auctioneer Commission	✓	?	✓		✓	✓			✓			
Board of Chiropractic Examiners		?		✓	✓	✓			✓	✓		✓
Energy Commission		✓				✓	✓			?		
Horse Racing Board		✓	✓		✓	✓			?		?	✓
New Motor Vehicle Board	✓	✓	✓	✓	✓	✓			✓			
Board of Osteopathic Examiners		✓	✓	✓	✓		✓	✓	✓	✓		✓
Public Utilities Commission		?				?	✓	✓		✓		✓
State Bar of California			✓	✓	✓	?	✓	✓	✓	✓		

1. Agency Wholly Unnecessary
2. Regulation Excessively Detailed
3. Regulation Cartel Oriented
4. Agency Dominated by Profit Stake Interests
5. Agency Includes Profit Stake Interests
6. Agency Purposes Addressable By Non Regulatory Measures
7. Agency Has Inadequate Practical Remedies to Accomplish Regulatory Purpose
8. Inadequately Staffed to Supervise Trade (Assuming Agency Justified)
9. Excessive or Irrational Barriers to Entry
10. Inadequate Quality Control of Existing Businesses/Tradesmen (Assuming Agency Justified)
11. Regulation at Wrong Level of Government
12. Wrongly in Constitution