Regulation is normally thought of as government regulation of the private sector, particularly business. However, there is a developing literature on regulation inside government, exploring the ways in which government regulates itself through a range of bodies which set standards for public sector organizations, monitors them and seeks to bring about compliance with those standards. Reading across economic theories of business regulation to regulation inside government, this article suggests that the current wave of reform inside the UK public sector implicitly reflects a public interest view of regulation. However, the analogous public interest justification for the regulation of business has been heavily criticized and regulatory failures have been suggested including regulation in the interest of regulated bodies, regulation in the interest of regulators and the high costs of operating regulatory systems.

The term ‘regulation’ is sometimes used in a broad sense to denote governing, the ways in which public purposes are decided on and implemented. However, ‘regulation’ has taken on a more specific meaning as achieving public goals using rules or standards of behaviour backed up by the sanctions or rewards of the state. In this sense, regulation is normally thought of in terms of government regulation of the private sector, particularly business (for example see Wilson 1980; Hancher and Moran 1989; Noll 1989; Foster 1992; Majone 1994; Ogus 1994; Doern and Wilks 1998). But there is a developing literature on regulation inside government, exploring the ways government regulates itself through a range of bodies which set standards for public sector organizations, monitors them and seeks to bring about compliance with those standards (Hood and Scott 1996; Hood and James 1997; Hood et al. 1998, 1999; Hood, James and Scott 2000).

Regulation inside government is a sizeable industry in the UK which has been growing over the past twenty years. By the mid-1990s there were 135 regulatory bodies costing about £770m to run each year (Hood et al. 1999, p. 23). The current wave of reforms proposed by the UK government further adds to this population. There are new ‘regulatory’ initiatives to achieve ‘Best Value’ in local government, and to raise ‘standards’, improve ‘quality’ and stamp out ‘failure’ across the public sector (Blair 1998; DETR
These reforms seem implicitly to reflect a public interest view of regulation, seeing it as a means to mitigate government failures and improve public welfare. However, the analogous public interest justification for the regulation of business has been heavily criticized. These critiques suggest that far from always furthering the public interest, regulation will itself often suffer from failures.

I REGULATION INSIDE GOVERNMENT

There are three features to regulation inside government. Firstly, the regulator has a degree of authority over regulated bodies and sets standards for them. Standards can relate to resource inputs, procedures, outputs or outcomes and can reflect a range of aims including, economy, efficiency, effectiveness, quality, and equality. Secondly, the regulator monitors performance and uses persuasion or direction of regulated bodies to change their behaviour. Thirdly, there is organizational separation of regulator and regulated bodies, so regulation is distinct from internal management within an organization (Hood et al. 1998; 1999). In the UK regulators include auditors (for example the National Audit Office and Audit Commission), inspectorates (for example OFSTED), ombudsmen (for example the Parliamentary Commissioner for Administration), and general overseers (for example some central government departments overseeing agencies and local government).

Regulation is related to the better known concept of accountability, conventionally defined as an obligation for a person or organization to justify actions to another body in terms of some authorization for the activity given by that body. Accountability involves several elements, namely, the assignment of duties or purposes, an obligation to answer for them, surveillance of performance and some reward or sanctioning for performance or non-performance (Thomas 1998, pp. 351–3). Both regulation and accountability involve the exercise of authority. But regulation focuses on authority relationships where an organization controls another at ‘arm’s length’ rather than internal management accountability and places particular emphasis on the role of standards or ‘rule-like’ structures in mediating these relationships. The UK literature on accountability has traditionally been concerned with accountability to elected officials and the public. Ministerial accountability in central government has been a key focus of research (see Dowding 1995 for an account of these debates). In contrast, regulation inside government explores the ways bureaucrats oversee other bureaucrats.

The current reforms being undertaken by UK government are increasing the population of regulators and are broadening the scope of regulatory activity (Hood, James and Scott 2000). Two themes of the 1999 Modernising Government White Paper are to compare public bodies’ performance against standards and to promote ‘quality’ systems in the public sector (Cabinet Office 1999). As part of his ‘vision’ for local government, Prime Minister
Blair has argued that local authorities need to participate in ‘Best Value’ – a framework of standards for quality and efficiency with central monitoring of systems and, in extreme cases, intervention and sanctioning where performance is seen as unacceptable (Blair 1998, pp. 19–20). A Best Value Inspectorate within the Audit Commission will oversee regular inspection of all local services to check on performance, expanding inspection to cover services including libraries, housing, planning and transport (DETR 1998). A new inspectorate-like body has been set up for health; the Commission for Health Improvement will support and oversee the quality of clinical governance and clinical services through a system of checks on local systems, offering support and taking action against poor performers. A new National Institute of Clinical Excellence promotes clinical standards and cost-effectiveness (DoH 1998a). Commissions for Care Standards are proposed to regulate care services including nursing and children’s homes (DoH 1998b). In central government and beyond, public service agreements set out targets for policy initiatives (Cabinet Office 1999).

So far, research on regulation has concentrated on defining concepts, mapping changes in the UK over the past twenty years and exploring the operation of regulatory systems in different policy sectors (Hood and Scott 1996; Hood and James 1997; Hood et al. 1999). We are at an early stage in developing theories to explain why regulation develops and to evaluate the costs and benefits of the activity, especially compared to the much better developed literature on regulation of the private sector. One way of remedying this lack of theory is to read-across the numerous economic theories of governmental regulation of business. This approach seems sensible for several reasons. Economic theories are based on the assumptions of methodological individualism and instrumental rationality, and enable a range of questions about regulation to be tackled using the same general approach. Regulation inside government involves the use of public authority to set, monitor and enforce standards and in this respect is not fundamentally different from the regulation of business. The main difference is that ‘government’ bodies are publicly owned and receive public funding. Following convention, public ownership is defined as a political oversight body’s claim over, or responsibility for, the financial or other residuals of an organization (in contrast to private ownership where owner-managers or shareholders claim this residual). Public funding consists of tax financed grants (rather than private payments by individuals in a market). The forms may be ‘mixed’ – with bodies having both public and private elements, for example a privately owned charity funded by government grants. The theories of business regulation need to be adapted to fit these ‘public’ contexts.

II REGULATION IN THE ‘PUBLIC INTEREST’?
The official explanation for the regulatory initiatives in UK Government seems implicitly to reflect a public interest justification for regulation inside
government, analogous to the better known public interest theory of the
regulation of business in conventional welfare economics. The public inter-
est is a slippery concept but this theory defines it as the interests of individ-
uals, promoted by free markets in which there is voluntary exchange of
goods and services with no market distortions, rather than the interests of
privileged groups. Regulation is explained as efforts to correct distortions
or ‘market failures’ which prevent markets from operating in the public
interest and is seen as a desirable activity in these circumstances (Breyer
1982; Noll 1989; Ogus 1994). There are several market failures. Firstly, exter-
nalities are situations where the prices used in exchange by individuals
do not reflect general social costs or benefits. Secondly, natural monopoly
involves economies of scale limiting the number of firms that can operate
in a market restricting competition and allowing monopolists to force up
prices and limit output. Thirdly, informational problems include cases
where consumers and producers do not have information about each other
or the product or service being exchanged. Legislators and regulators are
seen as essentially benevolent, designing and operating regulatory systems
to correct these failures and bringing about improvements to general well-
being. Regulatory initiatives include attempts to control prices and stop
monopolists exploiting their position, placing restrictions on behaviour
leading to externalities, and requirements to make information about pro-
duct quality or alternative producers available to consumers (See Breyer
1982; Noll 1989 or Ogus 1994 for a more extensive discussion).

Reading-across to the public sector, where there is public ownership and
funding and conventional markets do not operate, the public interest must
be redefined. It can be translated as the interests of individual taxpayers
and, broadly defined, users of public services as opposed to the sectional
interests of narrow interest groups who are able to exploit a privileged
position for their own benefit. The UK government’s justifications for the
reforms are fragmented and do not amount to an overarching, theoretically
informed, rationale. However, government statements seem to reflect pub-
lic interest aims. Prime Minister Blair argues that ‘Best Value’ is a
demanding framework, helping councils ‘to be efficient and to make sure
that residents receive quality services’, and are part of a project to produce
‘modern’ government for the British people (Blair 1998, pp. 1–3). Similarly,
the government argues that the Commission for Health Improvement will
oversee the quality of health care and contribute to a ‘one nation’ health
service (DoH 1998a, ch. 7). The public interest justification for regulation
inside government developed here spells out more comprehensively how
regulation might be expected to further public welfare.

The public sector analogy to ‘market failure’ is the idea of government
failure. Government failure occurs where co-ordination and control mech-
anisms end up favouring narrow privileged groups rather than the users
of public services and taxpayers. The focus here is on supply side failures
to do with the delivery of public policy rather than demand side failures,
such as those associated with voting systems used to decide on what should be produced. Adapting a framework devised by Hood (1996), there are three main alternatives to regulation which commonly appear in different guises in discussions about how to control and co-ordinate the delivery of public services. Firstly, self-control in which public bodies act alone or in a peer group with freedom from external oversight (for example professionals in education, social services and medicine who play a part in designing standards of conduct in these areas). Secondly, using the forces of competition in quasi-markets to structure behaviour and resource allocation (for example competition between providers of services for funding from purchasing authorities as previously used in the health sector). Thirdly, direct management involving hierarchical control of subordinates within an integrated organization with common staff and procedures (for example a traditional central government department with a tiered managerial structure). In some circumstances these forms will fail and regulation will improve public welfare.

A public interest account of regulation inside government might appear paradoxical, because if legislators and regulators designing regulatory systems are attempting to further the public interest then all public officials might be expected to do the same. But even under these circumstances coordination problems might require regulation, for example where one body is ignorant of the effects of its actions on other bodies. But the public interest account also views self-interested behaviour by public officials ‘down the line’ as a cause of government failure, even if regulatory bureaucrats are largely assumed to be above such behaviour. Public sector externalities arise where control and performance appraisal systems fail to reflect the wider effects of a public organization’s activities on the goals of other organizations. Thus, a school might exclude difficult students from classes to boost exam performance but this practice could have a detrimental effect on local crime rates, a problem which is handled by other bodies including the police and local authorities. Other failures arise where bureaucrats can exploit their monopoly position as providers of a service or where bureaucratic ‘agents’ can exploit ‘principals’ because they have an informational advantage about the activity they are performing. The consequences of these failures include goal displacement where the aims of a public body are altered by those running it, under or oversupply of public services where too much or too little is produced, wasteful production where services are produced at a cost in excess of what could be achieved, and difficulties in ensuring the quality of public services (Wolf 1979; Vining and Weimer 1990).

In the public interest account, each of the control forms is prone to different government failures, leading to a need for regulation. Self-control is the least suitable form for dealing with self-interested behaviour when these interests clash with the broader interests of taxpayers or service users. Both self-control and quasi-market controls have difficulties in dealing with
externalities, the incentive in these systems is for organizations to pursue their own goals regardless of the impact on others. Quasi-market control can help encourage competition which makes ‘agents’ more keen to please their ‘principals’ and can give the ‘principal’ more information about the potential performance of ‘agents’, if the quasi-market does not suffer from monopoly provision and information problems. Hierarchy is the most successful way to deal with externalities, by internalizing them within a single organization, allowing goals to be harmonized and encouraging information sharing, and can allow closer monitoring of agents. However hierarchy imposes costs of its own through reduced flexibility, so that those located in its lower echelons typically have to refer decisions up the line rather than acting on their own initiative.

Regulation can help mitigate these failures. It can improve the treatment of externalities by regulators introducing rules to encourage organizations to take account of their activities on other bodies and through regulators spreading information about the effects of different bodies’ actions on other parts of the public sector. Monitoring by regulators helps penetrate information asymmetry and expose fraudulent and wasteful behaviour by external verification of costs and performance. Regulators can uncover ‘cost padding’, evaluate the quality of services and suggest the budgets which should be given to public bodies. These features mean that regulation is most likely to be beneficial, and is most likely to be observed, in certain situations: firstly, where externalities make self-control and quasi-markets undesirable and the reduced flexibility caused by integrating agencies into a single hierarchy is unacceptable; secondly, where self-interested officials are able to exploit informational advantages and monopoly positions, making self-control inappropriate and preventing quasi-markets from operating effectively. If hierarchy is undesirable because of the associated inflexibility, then regulation is the preferable form of control. Regulation can also be used in combination with other types of controls to form hybrids. Regulation can be combined with self-control, with a regulator fostering professional norms by encouraging peer group review (for example the NHS Executive’s encouragement of clinical audit). Regulation and quasi-markets in combination involve the regulator structuring and managing the market, controlling entry and exit, and providing independent information to consumers (for example the provision of information to parents through school league tables). Regulation combined with hierarchy entails the regulator providing information and assistance to facilitate direct management control either by the regulator itself or other bodies (for example providing information to enable ‘hit squads’ to be sent in to run local public services).

The UK government seems to be motivated by some of these considerations in arguing for more regulation. For example, it is seeking to improve the treatment of ‘cross cutting’ issues where a public policy problem cuts across traditional organizational boundaries, and in so doing implicitly recognizes the problem of externalities. Their solution is more ‘soft’ forms
of regulation, where the emphasis is on mutually agreed standards, advice giving and spreading best practice. This policy is evident in the areas of social exclusion, women’s issues and criminal justice, with units or groups to co-ordinate action and efforts to align incentive and accountability systems to promote joint working (Cabinet Office 1999, pp. 17–18). The problems of ensuring efficiency and service quality in parts of the public sector which are subject to limited competition and where the quality of services is not easily observable have been given as reasons behind the more formal systems of standard setting and sanctioning in local government and health care (Hood, James, Scott 2000).

III REGULATORY FAILURES

There are good reasons to question the public interest account of regulation inside government because the analogous account of the regulation of business has been strongly attacked. Alternative economic models suggest that business regulation, far from being a solution to ‘market failures’, has failures of its own. The three main types of regulatory failure are summarized in table 1 below. The first two failures suggest that the benefits of regulation do not accrue to service users and taxpayers, but to regulators or regulated

| TABLE 1 Regulatory failures suggested by theories of business regulation |
|-----------------------------|------------------------------------------------------------------------|
| **Regulatory failure**      | **Theories**                                                           |
| Regulation captured by      | (1) Simple capture model in which regulated bodies lobby for regulation from which they benefit (Stigler 1971). |
| regulated bodies            | (2) Modified capture models under conditions of electoral incentives to create regulatory rents (Peltzman 1989). |
|                            | (3) The later stages of the regulatory life cycle model once the initial drive for regulation has subsided and regulation becomes increasingly owned by regulated groups (Bernstein 1955). |
|                            | (4) Simple principal-agent model focusing on the difficulties a regulator ‘principal’ faces trying to influence a bureaucrat ‘agent’. |
| Regulation in the interests | (1) More complex principal-agent models acknowledging the principal-agent relationship between politicians and regulators as well as between regulators and regulated with the associated danger of regulated bodies inducing lax enforcement from regulators by giving them benefits (Laffont and Tirole 1993). |
| of regulators              | (2) Regulatory state explanation of regulatory growth in terms of the benefits for bureaucrats involved in devising new regulations (Majone 1994). |
| Costly regulation          | (1) Strategic enforcement model with ‘costly’ lack of cooperation between regulators and regulated bodies (Scholz 1991). |
|                            | (2) Transaction cost accounts stressing the cost of institutional arrangements, some versions also suggest that concentrated interest groups are likely to dominate regulation (Horn 1995). |
bodies instead. The third failure suggests that regulation is a costly enterprise even if attempts are made to pursue the public interest. Resources will tend to be consumed in ‘cat and mouse’ games between regulator and regulated bodies and will be taken up by institutional structures designed to try and prevent regulation reflecting narrow sectional interests. The failures are not fully mutually exclusive; in particular, principal-agent theories point to benefits for both regulators and regulated bodies from collusion against the public interest.

**Regulation in the interests of the regulated**

Regulatory ‘capture’ theory suggests that the interests of the regulated bodies cause regulation to develop and grow (Stigler 1971). Business groups will lobby for regulation to shut potential new entrants out of their market and enable them to raise prices. Rational vote-seeking politicians ‘sell’ regulatory policy to the highest political bidder in terms of votes and money, particularly campaign contributions. The winning bidders will tend to be the most concentrated lobbyists which will tend to be business, at the expense of more diffuse and less organized interests, which will tend to be consumers. Regulators, who themselves benefit from expanding activity, use the state’s regulatory power to transfer available wealth from less organized to more organized groups.

The most straightforward read-across is that demand for regulation inside government will typically come from incumbent producers supplying public services. Focusing on individuals working in publicly owned bodies, the key maximand must be altered from profit-making to other motives because bureaucrats do not own the residual generated by their activities. There are several motivations conventionally used in the economic or rational choice literature on bureaucracy. These include budget/output maximization where a bureau tries to produce as much of the good it delivers as possible (Niskanen 1971); ‘slack’ or inefficiency maximization where budgets are pushed up and output down to maximize the resources available for pursuing bureaucrats’ own goals rather than those they have been set by their political masters (Niskanen 1975); ‘bureaushaping’ work-related benefits where officials seek to do ‘interesting’ work rather than routine, day-to-day, activities (Dunleavy 1991) or a combination of budget/output maximizing and ‘bureau-shaping’ (James 1995). In a similar way to regulation of the private sector, regulators can limit entry to the production of public services, protecting the monopoly position of bureaucrats against potential competitors. Additionally, instead of regulating prices paid by consumers in decentralized markets, regulators recommend a budget level based on their assessment of the cost of providing services. Thus audit bodies and inspectorates evaluate the value for money of public organizations and this information is fed to funding bodies. These processes give public officials an incentive to lobby regulators for favourable regulation. In the capture theory the mechanism for influence is the electoral...
process. Regulation is auctioned by politicians in exchange for votes or vote-fungible items from bureaucrats. This argument resembles theories which suggest that bureaucrats will vote for parties which expand the size of the public sector, contributing to government growth (Blais and Dion 1991). Where the electoral strength of bureaucrats is greater than general taxpayers, who ultimately pay most of the costs of regulation, regulation favourable to bureaucrats will emerge. Regulation can be expected regardless of whether there are public interest reasons for its existence, and will be excessive.

In a more flexible version of the ‘capture’ idea, Peltzman (1989) suggests that capture is not a forgone conclusion but is contingent, depending on what happens to the available ‘rent’ from regulation and the configuration of coalitions around it. Regulation grows only when politicians believe that there are further electoral payoffs from transferring more ‘rents’ to regulatory beneficiaries at the cost of those who have to pay, such as winning producers’ votes by loading more pro-producer regulatory costs on consumers and as a consequence compulsorily transferring wealth from consumers to producers. But regulation can just as easily move in the opposite direction if these conditions do not apply. If ‘rents’ from regulation become depleted over time then regulation may decline – for example through incentives for those who produce the surpluses (confiscated by the regulatory regime for distribution to politically favoured groups) to dissipate those surpluses (Peltzman 1989). In terms of regulation inside government, if the most concentrated and resource-rich interests are inside the public bureaucracy, regulation inside government can be expected to close off public sector markets to new producers. However there may be increasing opposition from taxpayers and potential rival private sector providers which may periodically lead to deregulation.

These models resemble an earlier, ‘life cycle’ theory of regulation which is not a fully economic model but has elements of individual instrumental behaviour by actors. Bernstein’s (1955) model conceives regulation as a response to disaster, where a scandal or catastrophe will override ‘normal’ political patterns, open a policy ‘window’ and put a regulatory issue on the agenda. The implication is that ‘rent-seeking’ alone may be a necessary, but is not a sufficient, condition for regulation. Some external spark changing public or legislator consciousness is needed to touch off the process. Bernstein argued that as the original crisis or scandal which prompted regulation receded in time, the nature of regulation tended to change. As political support for regulators tends to recede, the agency’s backing for placing demands on its regulatory clients is weakened. At the same time, ambitious or committed individuals who were attracted to the regulatory unit in the early days of high political saliency will tend to become disillusioned or move on to new areas of top political priority. So that the agency’s staff become proportionately less committed to its substantive goals and more willing to make compromises to save their jobs. In such conditions, accord-
ing to Bernstein, regulation would tend increasingly to be ‘owned’ by regulated bodies rather than by more general or latent stakeholders, resulting in a form of capture.

The public interest account assumes that politician ‘principals’ control public service providers who are their ‘agents’ and use regulators to try and get the ‘agents’ to act in their interests. Regulators help politicians by monitoring the cost of provision, ensuring that bureaucrats involved in production are not using budgets inefficiently, and assessing the quality of services. However, principal-agent models suggests that regulators will always be restricted in the extent to which they can get regulated bodies to do everything they would like them to; the potential of these models for examining the UK education and health sectors has been noted (Barrow 1996). The ‘simple’ principal-agent model focuses on the relationship between regulators and regulated bodies. It suggests that the regulator must secure a trade-off between achieving the aims of gaining public services at the lowest possible cost and leaving public providers of service with the lowest possible surplus (of budget in excess of that needed to provide a given level of service). This trade-off occurs because the regulator does not know a provider’s true level of costs and providers need the incentive of a potential surplus of funding above true cost to motivate them to reduce costs. In the private sector the surplus is profit which acts as an incentive. In public bureaucracies, surpluses are an incentive because they provide officials with funds which can be spent in a discretionary manner (rather than being used to achieve mandated goals), providing a cushion against uncertainty and funds for pet projects. If the regulator suggests that a regulated body receive a fixed budget estimated at the likely cost of running a service, then there is an incentive for the provider to produce at the lowest possible cost to try and maximize its surplus. If the provider is successful then costs will have been driven down but the provider will be left with a surplus. On the other hand, if the regulator sets a budget level related to whatever costs the provider incurs then the provider will not be left with a surplus but there is little incentive for the provider to produce at the lowest possible cost.

**Regulation in the interests of the regulators**

A more complex principal-agent model incorporates a chain of principal-agent relationships between voters and politicians, politicians and regulators and regulators and regulated bodies and includes multiple principals and agents in each part of the chain. The principal-agent relationship between politicians and regulators can be exploited for the benefit of regulators and regulated bodies. Laffont and Tirole (1993) present a principal-agent model along these lines consisting of a legislature trying to regulate a firm which has an informational advantage about its costs. The legislature employs a regulatory agent to find out more information about the firm’s costs.
Reading-across to regulation inside government, the model can be translated as a legislature trying to regulate an inefficiency or budget/output maximizing bureaucracy using a public audit office or an inspectorate to find out about the costs of production. The outcomes for budget levels and outputs depend, among other things, on whether the regulated body can induce the regulatory agent not to pass on information to the legislature about the true level of costs. The level of inducement depends on the distribution of benefits (concentrated benefits will encourage collective action by bureaucrats and high inducement), and the ‘ethics’ environment which affects the cost of inducement. A highly ‘ethical’ environment makes direct bribes and inducements difficult and raises the costs of influence, which has to be conducted by other means. Laffont and Tirole do not specify the inducements for regulators in much detail, but possible sources of inducement have been suggested in other accounts. For example, a model of the ‘revolving door’ of staff moving between regulators and regulated private sector bodies suggests that the prospect of attractive jobs working in regulated bodies will encourage lax enforcement (Makkai and Braithwaite 1995).

An alternative model pointing to ways in which regulators benefit from regulatory developments is Majone’s (1994) account of the rise of the regulatory state in Europe. The model is not a fully economic one, but has elements of this approach. Majone seeks to explain the increase in the scope and complexity of EU regulation, in spite of the apparent preference for simplicity in the Treaty of Rome. He argues that the regulatory state has grown within the EU bureaucracy because it is the only available channel for ambitious Eurocrats seeking to build their careers. Tight restraints on policies involving the direct expenditure of public funds, given that the funds available are pre-empted by CAP and a few other programmes, means expansion of regulatory activities is the only effective way for the EU Commission to increase its role.

In regulation inside government, if the scope for new spending initiatives is under attack, new regulatory developments may be a suitable vehicle for the ambition of bureaucrats and policy entrepreneurs. The ‘bureau-shaping’ model (Dunleavy 1991) suggests that when top bureaucrats come under budgetary pressure from politicians, they will aim to reshape and reorganize the bureaucracy into a different form that makes their own jobs more pleasant and satisfying, distancing top bureaucrats from tedious routine. Combining the Majone insight with bureau-shaping motivations, new regulatory initiatives might be seen as a strategy for individual officials seeking to make a name for themselves by introducing a new policy. Regulatory initiatives are also a collective strategy for officials seeking to reorder their work by replacing day-to-day, hands-on management with more attractive regulatory work using strategic control and selective intervention. High-level, policy-oriented central government bureaucrats are a closely knit group who are more able to overcome collective action problems than many other groups in the public sector and pursue these sorts of strategies (James
They may also be able to push the costs of regulation, such as the substantial costs for regulated bodies incurred in complying with standards, to more diffuse bureaucratic groups further down the line or in operational, local or regional sectors.

**Costly regulation**

Even in systems where regulators and regulated bodies do not greatly benefit at the expense of wider interests, pursuing public interest goals uses up resources in the cost of running regulatory systems. Scholz (1991) models enforcement and compliance between a regulator and regulated firm as a ‘Prisoner’s Dilemma’ game. He suggests that the relationship between regulator and regulated body will either take the form of a ‘deterrence’ equilibrium (in which the regulator adopts a harsh enforcement policy and the regulated bodies a minimal compliance policy) or a ‘voluntary compliance’ equilibrium (in which the regulator adopts a flexible enforcement policy and the regulated body a flexible compliance policy). He argues that regulated bodies will find it in their own individual interests to operate with a minimal compliance strategy regardless of whether regulators are harsh or lenient, because they try to save resources and pursue their own aims. Regulators will prefer to operate with harsh enforcement policy regardless of whether regulated bodies undertake either minimal compliance or flexible strategies because they try to achieve their aim of enforcing regulation. However, the regulatory outcome is determined by the actions of both parties. The result is the uncooperative ‘deterrence’ equilibrium with minimal compliance and harsh enforcement, even though both groups would be better off in the ‘voluntary compliance’ equilibrium. Under some conditions of repeated ‘plays’ of the game, the regulator and regulated body may be able to agree ‘voluntary compliance’ strategies, although there will be a temptation for both players to ‘defect’ to their individually preferred strategies.

Transaction cost theory similarly focuses attention on the costs of running the regulatory system. The theory develops from the recognition that neoclassical economic theory ignores the costs which arise from impediments to reaching and enforcing agreements in markets. Transaction costs arise because of bounded rationality and opportunism in a world where uncertainty prevents everything being written down in advance. Bounded rationality is individuals’ limited ability to realize their intentions; people are hampered by their limited knowledge, foresight, skill and time. Opportunism is transactors’ willingness to attempt to obtain a more favourable distribution of the gains from trade by reneging on agreements or in some way exploiting trading partners. Opportunism can involve behaviour within agreements, so called ‘moral hazard’ such as shirking or alternatively trying to get favourable terms for the agreement in the first place (see Milgrom and Roberts 1992, ch. 2 for a more extensive discussion). Reading-across to regulation inside government, these problems are used as justifications for
regulation in the public interest account, for example where opportunism and monopoly provision make self-control ineffective. However, the transaction cost perspective emphasizes the costs of running the regulatory system itself, for example in setting up monitoring systems to prevent regulators from pursuing their own interests where these diverge from broader interests.

The transaction cost perspective has been synthesized with an interest group model by Horn (1995) to explain institutional choice in government regulation of business. Horn’s model concentrates on the extent to which politicians allow a regulatory body to make its own decisions and act independently of political control once it has been set up. The result is a model that not only emphasizes the cost of organizing regulatory systems but also suggests that the interests of regulators and regulated bodies may come to dominate these systems. The key relationship in Horn’s analysis is voters’ or constituents’ transaction or ‘exchange’ with the ‘enacting legislature’ which sets up the regulatory system. The model resembles Peltzman’s model of interest groups lobbying for regulation because constituents vote for forms of regulation from which they benefit, but it adds an extra dimension by including transaction costs. Some of these costs arise because the promises made by an enacting legislature may lack credibility; a new legislature may be elected in a future period and overturn the enacting legislature’s regulatory policy. The enacting legislature must be able to commit itself to provide continuing benefits to the constituents after the law establishing the regulatory system has been enacted. This sets up transaction costs because apparently inefficient (in terms of production or other costs) organizational structures may be needed to protect these benefits against being overturned (Horn 1995, ch. 2). In particular, regulatory and other agencies may be given autonomy to pursue their missions without interference from politicians to give credibility to promises made by the enacting legislature about the continuation of the policy. This autonomy means that even if a new legislature was elected with different regulatory policy preferences it would find it difficult to overturn the original enacting legislature’s policy, at least for some period. Offsetting the benefits from autonomy are ‘agency problems’, where the regulator pursues its own agenda rather than that of the enacting legislature. The trade-off between ‘commitment’ and ‘agency’ problems is the key determinant of the institutional structure of regulation. The outcome of Horn’s model for regulation inside government depends in part on the lobbying power of different groups of constituents. The need to delegate some autonomy to regulators because of the commitment problem means that regulation in the interests of the regulator is a likely outcome and if regulated groups can mobilize their interests and provide inducements to regulators then regulatory capture is also likely. Structures to prevent these outcomes themselves use up resources and contribute to the costs of running the regulatory system.
CONCLUSION

There are good reasons to question the UK government’s apparent faith in a public interest justification for regulation inside government. An analogous justification has been heavily criticized in the economic literature on the regulation of business. Alternatives to the public interest theory suggest three types of regulatory failure, which are not fully mutually exclusive. Firstly, regulation may reflect the interests of regulated bodies. Secondly, regulators’ interests may dominate regulatory systems. Thirdly, there are high costs in operating regulatory systems even when they are primarily geared to promoting the public interest.

However, the public interest and regulatory failure perspectives are not completely inconsistent. In an attempt to understand the limits to the regulation of business, Becker (1983) modified Peltzman’s interest group lobbying model to incorporate elements of the public interest model. Becker’s model suggests that the regulatory policies which arise from interest group behaviour are limited by the dead-weight losses they bring about. These losses are not simply transfers to regulated groups from other people but pure losses. For example, in terms of regulation inside government, regulation sometimes limits the provision of services to publicly approved suppliers. This restriction may cause underproduction of a service and lost benefits from units of production which would have been produced in the absence of regulation. User groups may lobby for regulation to be relaxed and production expanded. By this reasoning, regulation is likely to be less extensive than the Stigler and Peltzman models suggest.

The relative practical importance of the different theories is a matter for empirical investigation, which is part of a developing research agenda (see for example Hood et al. 1999; Hood, James, Scott 2000; Cope and Goodship 1999). Research on UK central government suggests that the regulatory forms used to control agencies at ‘arm’s-length’ from departments, especially performance targets, have contributed to performance problems in some types of agency (James 2000). Taking the largest agency, the Benefits Agency, as an example, the Agency performed well on a crude efficiency measure of cost per unit of workload, but had serious shortcomings in broader efficiency and effectiveness. These problems included substantial inaccuracy in payments amounting to on average £1,500m of a budget of £80,000m per year. There were further difficulties in joint working with local authorities who relied on information supplied by the Agency to administer Housing Benefit. This information was often difficult to obtain, inaccurate or was provided only after a delay. The regulatory regime seems to have contributed to these problems. Until the late 1990s, performance targets focused the Agency’s attention on benefit clearance times rather than accuracy and were narrowly focused on the Agency’s own performance rather than externality effects on local authorities. These problems led to a major re-organization of welfare delivery which is currently in
progress. In terms of the public interest account, at best, this experience suggests a well meaning but flawed attempt at regulation. But the case seems more consistent with the bureau-shaping model outlined in section III. The creation of the Agency enabled officials in the department to control the activity at arm’s length through the regulatory regime and concentrate on policy work rather than getting directly involved in day-to-day, hands-on, management issues which might have been a more suitable approach.

Reading-across economic theories of business regulation suggests possible reforms to regulation inside government. These reforms are of two types: firstly to strengthen the alternatives to regulation discussed in section II, and secondly to make regulation itself more effective. An alternative to regulation is to try to make self-control in the public sector work more effectively. Internalizing externalities through the clear allocation of property rights was suggested by Coase (1960). He argued that, if bargaining is costless, those suffering the effects of an externality could band together to try and bribe the people causing the externality to change their behaviour. Thus, people living near a factory which pollutes their air could offer to pay the factory to use an alternative non-polluting production technique. The allocation of the property rights determines who compensates whom; in this case local residents do not have the right to clean air and must pay the factory. This solution can be read-across to the hypothetical public sector externality discussed in section II. In this example, a school excludes disruptive students in an effort to improve the education of other students and raise exam results. One result is that excluded students commit crime outside the school which is the responsibility of other bodies including the police and local authorities. Using the Coase solution, the school could be bribed by a transfer of budget from the police and local authorities to set up extra classes to provide lessons for the disruptive students without harming the education of others and removing the externality. Another alternative to regulation commonly suggested in the literature on the regulation of business is to encourage more competition (Breyer 1982). According to these arguments, breaking up public sector monopolies and introducing competition with the private sector or competition between different public sector provider units reduces the need for regulation.

A second type of reform focuses on making regulation work more effectively. One way is to use regulation in combination with other control types so that, for instance, competition between regulated bodies can be used by regulators to gain more information about their behaviour. League tables for local authority performance collated by the Audit Commission are an example of structures which stop short of full contestation of provision but enable regulators to see the scope for potential improvements by playing off similar bodies against each other. Competition between regulators is another alternative (Hood et al. 1999, pp. 215–219). Regulators’ budgets could be devolved to regulated bodies and these bodies allowed to choose their regulators and pay a fee to them, subject to minimum standards being...
met. Then competitive pressures might be expected to bring down regulators’ costs as they attempt to reduce the fees charged to regulated bodies.

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