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# Regulation (Agencies) versus Litigation (Courts) An Analytical Framework

Richard A. Posner

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## 1.1 Introduction

Economic analysis of law treats common law fields, especially tort law—which provides legal remedies for physical, mental, or financial injuries caused by negligence, medical malpractice, nuisance (which includes pollution), defamation, defective products, misrepresentation, or other wrongful conduct—as forms of regulation. The emphasis is thus on the deterrent effect of the threat of liability, rather than on the compensatory role of liability; compensation is thought better provided for by insurance. Common law is thus conceived of as regulation by judges—by judges not only because common law remedies are obtained by means of lawsuits against injurers but also because common law doctrines are made by judges.

My objective in this chapter is to compare common law (including federal common law; i.e., the body of common law made by federal judges—indeed, my primary concern is with federal regulation) with administrative regulation as methods of social control. More precisely, my objective is to compare common law regulation with administrative regulation, while giving due recognition to the fact that administrators often use common law methods of regulation and that judges sometimes use methods similar to those of

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I thank Daniel Kessler, and two anonymous referees, for helpful comments on an earlier draft of this piece. I have decided to spare the reader the burden of footnotes and references. Much of the key literature on which I build is cited in the editors' introduction; of particular note is Steven Shavell, "Liability for Harm versus Regulation of Safety," *Journal of Legal Studies* 13:357–74 (1984). See also the discussion and references in chapter 13 ("The Choice between Regulation and Common Law") of my book *Economic Analysis of Law*, 7th ed. (Aspen Publishers, 2007).

administrative agencies. (The principal example is the “regulatory decree,” under which courts will administer rules, often agreed to by the parties—governing institutions, such as school systems or prison systems—that have been determined to have violated constitutional law.) Nevertheless, judges are considerably more comfortable with the common law approach, and agencies that rely on common law methods to regulate are generally thought to have forgone the distinctive advantages of administrative regulation. So there is some utility to contrasting “litigation” with “regulation” as alternative methods of social control, while recognizing the overlap.

But besides noting the overlap, I need to point out an intermediate position between common law and administrative regulation. In common law adjudication, the judges make as well as apply the doctrine. In administrative regulation, the judges play a limited role of deferential judicial review of the administrative agency’s decision. But in between is the judicial enforcement of statutes that are not administered by a regulatory agency. For example, although the Federal Trade Commission has antitrust enforcement authority, most antitrust cases are brought by public officials or private firms in federal courts that interpret and apply the antitrust laws without the intervention of an administrative agency. The judges’ role is nominally interpretive but owing to the age and vagueness of the antitrust statutes in fact resembles common law lawmaking. But for simplicity I will focus on the contrast between pure common law adjudication and administrative regulation.

My analysis is normative; the question I address is what the better method—litigation or (administrative) regulation—would be, from the standpoint of economic efficiency, for regulating a particular activity. I leave to other work (some in this volume) positive questions about the choice between litigation and regulation, such as the political and cultural forces (including legalistic and individualistic traditions, and the influence of the legal profession, which has been said to be the American counterpart of European aristocracy and elite bureaucracy) that shape American government. No competent student of regulation thinks that the line between common law and regulation has been drawn primarily on the basis of comparative economic advantage.

From a normative economic standpoint the goal of regulation, whether by courts or by agencies, is to solve economic problems that cannot be left to the market to solve—such as problems created by positive or negative large externalities that market forces cannot internalize because transaction costs are too great for the Coase theorem to apply. Even so, it is still necessary to consider whether public control is justified, because the costs may exceed the benefits from internalizing the externalities, or because an intermediate form of regulation between pure market forces and public control may be superior to both; I refer to industry self-regulation, illustrated by board certification of physicians, hazing-type medical education to instill norms and create a

“high commitment” environment (“professionalism”), contracts between patients and physicians and between consumers and producers, rulemaking and standards-setting by trade or professional associations, and arbitration or mediation to resolve disputes. If public control is not superior to private ordering, the next question—the positive one—is why the private alternative has been rejected.

## 1.2 Characterizing the Differences between Regulation and Litigation

Regulation and litigation tend to differ along four key dimensions: (a) regulation tends to use *ex ante* (preventive) means of control, litigation *ex post* (deterrent) means; (b) regulation tends to use rules, litigation standards; (c) regulation tends to use experts (or at least supposed experts) to design and implement rules, whereas litigation is dominated by generalists (judges, juries, trial lawyers), though experts provide input as witnesses; and (d) regulation tends to use public enforcement mechanisms. Litigation more commonly uses private enforcement mechanisms—private civil lawsuits, handled by private lawyers although the decision resolving the litigation is made by a judge (with or without a jury), who is a public official (the jurors are *ad hoc* public officials).

### 1.2.1 Ex Ante versus Ex Post

The first method is illustrated by speed limits, the second by personal-injury suits for negligence. As in this example, the two types of regulation are frequently conjoined. The regulation of highway safety is a complex mosaic of *ex ante* regulation (including speed limits and other safe driving rules, federal safety design standards, standards for the design and maintenance of highways, and the licensure of drivers) and *ex post* regulation (such as suits for negligent driving, product liability suits for defects in the design or manufacture of motor vehicles, and criminal prosecutions for drunk or other reckless driving).

*Ex ante* regulation can, as I said, be judicial as well as administrative, as in preventive detention, injunctions, and regulatory decrees, and *ex post* regulation can be administered by agencies as well as courts, such as the Federal Trade Commission and the National Labor Relations Board, which operate mainly by trial-type proceedings conducted after a violation of the laws administered by the agency has occurred.

*Ex ante: pros.* The *ex ante* approach promotes clarity of legal obligation and therefore presumably better compliance (fewer inadvertent violations) by laying down rules in advance of the regulated activities. *Ex ante* regulation is activated before there is a loss, unlike a lawsuit; it can be centrally designed and imposed (for example, by a single agency such as the Food and Drug Administration, as opposed to a decentralized judicial system); and it is enforceable by means of light penalties, because the optimal penalty for

creating a mere risk of injury is normally lighter than the optimal penalty for causing an actual injury. This means, however, that *ex ante* and *ex post* regulation actually are inseparable; because compliance with rules is never 100 percent, there must be a machinery for punishing violators, though the machinery may involve penalties meted out by the regulatory agency itself, with judicial involvement limited to judicial review of the penalty proceeding. But while rules involve heavy fixed costs (i.e., designing the rule in the first place), if they are very clear and carry heavy penalties compliance may be achieved without frequent enforcement proceedings, so marginal costs may be low. Rules are therefore attractive when the alternative would be vague standards, resulting in frequent actual or arguable violations and hence frequent enforcement proceedings.

As this discussion shows, *ex ante* regulation and rules have an affinity. *Ex ante* regulation enables exploitation of the economizing properties of rules as preventives. With vague standards, the regulatory emphasis shifts to seeking deterrence by proceedings to punish violators.

But the affinity between *ex ante* regulation and rules requires a qualification. Consider the criminal penalties for the sale of illegal drugs. The underlying criminal prohibition is a flat, clear rule, but compliance is achieved almost entirely by threat of punishment, which is *ex post*. Contrast that with the regulation of legal drugs, where, although there is *ex post* enforcement, including products liability suits, the emphasis is on testing new drugs in advance for safety and efficacy and refusing to allow drugs to be sold that flunk the tests.

*Ex ante: cons.* *Ex ante* regulation narrows the information base because when it takes the form of rules, it buys precision at the cost of excluding case-specific information that the promulgators of the regulation either did not anticipate or excluded in order to keep the regulation simple (i.e., to keep it a rule). Standards (such as negligence) versus rules (such as a numerical speed limit) allow much more information to be considered in particular cases. In doing so, however, standards not only reduce predictability; they also, as noted before, veer into *ex post* regulation, because vague standards beget disputes that require litigation over alleged violations to resolve. In addition, *ex ante* regulation, like preventive care in medicine, can burden much harmless activity, such as safe driving in excess of the speed limit. (Compare screening the entire population for medical conditions that afflict only a few people.) This is related to the fact that rules exclude relevant circumstances for the sake of clarity.

When *ex ante* regulation takes the form of licensure rather than merely prohibition—compare a requirement of a building permit to a speed limit—costs of compliance may soar, along with an increased risk of bribery if the permit is highly valuable.

*Ex post: pros.* *Ex post* regulation may require only rare interventions (again compare screening for medical conditions with treatment if and

when a condition produces symptoms) and zero in on the limiting case in which a rule or standard achieves 100 percent compliance, though there may of course be costs of compliance. Ex post regulation economizes on administrative expense because intervention is sporadic, and utilizes both case-specific information (including information about causation and victim fault, and other information obtained after regulation is promulgated and in the context of a particular injury) and adversary procedure, which may increase accuracy. There is more information, including up-to-date and case-specific information, and it is screened and weighed more carefully because it is presented in a contested proceeding. In its private (as distinct from public) and adversary character, litigation as a regulatory approach borrows the methods of competitive markets.

The information advantage of ex post regulation is especially pronounced when the ex post standard is strict liability, meaning that the injurer is obligated to pay damages even if he or she could not have avoided at reasonable cost inflicting the injury. An example is an injury caused by the use of explosives, viewed as an ultrahazardous activity, in building a tunnel. Potential injurers have a strong incentive to balance the costs and benefits of the hazardous activity in order to decide whether or on what scale or in what circumstances engaging in the activity is cost-justified, and they have ready access to the necessary information.

The earlier example of illegal drugs illustrates the case in which ex post regulation does not refine a preexisting rule or standard. The laws are clear and their enforcement is concerned simply with punishing violations. The enforcement is also, however, largely ineffectual. For although the penalties are stiff, the expected cost of punishment is for many potential offenders low relative to the expected profits of drug trafficking because of the ease of concealment of illegal activity—a general problem with “victimless” crimes, since there is no one to complain to the authorities. But this is a case where both ex ante and ex post regulation are failures, and the best solution would be decriminalization coupled with excise taxation—though that could be considered a form of ex ante regulation, though remote from the usual examples.

*Ex post: cons.* Ex post regulation, typified by common law adjudication, with its heavy emphasis on standards (such as negligence and good faith) in preference to rules, involves high costs per case compared to adjudicating a speeding ticket. This is partly because of the additional information generated by a proceeding focused on a specific injury inflicted in particular circumstances. More information cannot only make a proceeding more costly but also create more uncertainty and as a result more variance in outcome; uncertainty also makes it more difficult to monitor the performance of the judge or other regulator to make sure he or she is competent and honest. Furthermore, a point related to the fact that the optimal penalty when an injury has occurred is greater than when a risk has been created that has

not yet materialized, the injurer may not have sufficient resources to pay the penalty. There are also problems of proof when the cause of an injury must be proved. The problems are illustrated by cases in which exposure to radiation increases the incidence of cancer, but it is impossible to determine whose cancers were due to the radiation and whose would have occurred anyway. This particular problem, however, can be solved, at least in principle, by class actions that amalgamate claims of probabilistic injury of all persons who had been exposed to the hazard in question.

Since deterrence is unlikely to be 100 percent effective, ex ante regulation is strongly indicated when the regulated activity can give rise to catastrophic injury. The greater the injury if deterrence fails and the likelier deterrence is to fail, the stronger the case for ex ante regulation. Even if 99 percent of building collapses, but only 10 percent of drug offenses, can be prevented by ex post regulation (suits for negligent design or construction in the first case, criminal punishments in the second), the social cost of the 1 percent of building collapses may exceed the social cost of the 90 percent of drug offenses. If it also exceeds the cost of prevention by the enactment and enforcement of building codes, then ex ante regulation is justified in the building's case. Reinforcing this conclusion is the fact that positive correlation between the gravity of the injury and the likelihood that deterrence will fail. They are positively correlated because the limited solvency of potential injurers is likely to make the expected cost *to them* of the injury (for remember that we are assuming a grave injury) lower than the expected social cost.

A similar example is public inspections of restaurants and food-processing plants versus relying entirely on threat of negligence suits to prevent food poisoning. In the case of restaurants, the owners would often be judgment-proof, so in the absence of a system of public inspections people would be very reluctant to patronize a small or new restaurant. In the case of food-processing plants, carelessness can result in mass injuries the costs of which to the victims might exceed the ability to pay of the negligent food processor.

This point also helps to explain the different regulatory systems for new drugs and for medical procedures. A drug sold to millions of people can, if it is unsafe, wreak enormous harm, whereas individual cases of medical malpractice injure only one patient. Moreover, it is feasible to test every new drug, and thus determine safety in advance, but infeasible to require physicians to seek approval from a regulatory agency for every procedure they perform. Consistent with this analysis, ex ante regulation is the dominant mode of regulation of new drugs, while ex post regulation in the form of medical malpractice suits is the dominant mode of regulation of medical treatment. Medical education and apprenticeship (residency) also play a major role in preventing malpractice, but that is not the focus of the training.

Thus far I have assumed that the cost of an injury can be determined. But often it cannot be, at least satisfactorily. Examples are death, disfigure-

ment, disability, emotional injury, and many forms of environment damage, including reduction in species diversity. Economists have developed methods of estimating such costs, but they are crude approximations at best to the underlying loss in utility or welfare, and can be elided by *ex ante* regulation that averts the loss entirely—although a determination of how much to spend on such regulation should, from an efficiency standpoint, depend on an estimate of the cost of the losses that it will avert.

A timely example of a situation in which difficulty of measuring costs, combined with difficulty of estimating causal responsibility and aggregating claims, argues strongly against *ex post* regulation is the economic downturn triggered by the financial collapse of September 2008. It is quite impossible to see how *ex post* regulation could protect the economy from the macroeconomic consequences of an unregulated business cycle.

A related point is the limited feasibility of *ex post* regulation as a control over official misfeasance, other than corruption. Although the successive Federal Reserve chairmen Alan Greenspan and Ben Bernanke committed mistakes that played a substantial role in the financial collapse, it is unlikely that the mistakes would have been averted if Federal Reserve chairmen were suable for the consequence of unsound monetary policy or bank regulation.

A broader problem that this example illustrates is the difficulty of *ex post* regulation as a means of deterring individual as distinct from corporate or other institutional conduct. Individuals are rarely wealthy enough to be worth suing, although physicians, other professionals, and wealthy businessmen are exceptions; and while they can be required to (and will often choose voluntarily to) buy liability insurance, this creates a moral hazard problem when insurers are unable, or are forbidden, to calibrate premiums to the risks of liability created by particular insureds. If all victims of unlawful conduct are fully compensated, there is no social loss. But because of loss limits in insurance policies, and uncompensated losses even in an efficient system of private law (the resources consumed when a person is injured—for example, in the medical care that he or she receives—are a deadweight loss that compensation does not restore), the reduction that liability insurance brings about in the deterrent effect of threat of litigation is a social loss.

### 1.2.2 Rules versus Standards

I elaborate here on the comparison that I made earlier between rules and standards as regulatory techniques. I noted the (loose) association between rules and *ex ante* regulation on the one hand and standards and *ex post* regulation on the other.

A rule abstracts from a number of relevant facts (as in a numerical speed limit, which ignores other circumstances bearing on the danger caused by driving). A standard, such as “due care,” or “unreasonable restraint of trade,” or “recklessness,” is open-ended because it directs the judge or jury



or other regulator to consider the particular circumstances in which a violation is alleged.

*Rules: pros.* Rules tend to be simple and clear, which reduces enforcement costs and facilitates monitoring of the court or other agency that applies the rules to particular facts. The simplicity of rules and the ease of monitoring compliance with them make them especially attractive for societies in which the judiciary is prone to incompetence and corruption.

*Rules: cons.* Yet often rules are not really simple and clear, because of pressure for exceptions and the boundary issues created by exceptions; it may be unclear whether a particular case falls within the general rule or within one of its exceptions. The answer to such a question is usually found by considering the purpose behind the rule and the exception in question, and that is the sort of analysis employed when standards are being applied.

Rules tend also to be crude, because they exclude relevant facts (such as, in the speed-limit example, traffic conditions, weather and time of day, emergencies, and driver skills). Thus, they rest on a narrower information base than standards. That exclusion also makes them somewhat arbitrary, and as a result counterintuitive. “Being careful” is intuitive; driving below 50 mph is not, which is why speed limits have to be posted. Rules, in contrast to standards, tend also to separate rule creation from application: legislatures promulgate rules, courts apply them. Common law courts both create and apply standards, and there are efficiency gains from vesting both functions in the same organization.

*Standards: pros.* Standards are the inverse of rules, so that the disadvantages of rules become the advantages of standards. They are flexible, intuitive, and generate and utilize more information, including information generated after the standard was initially adopted (that is a serious problem with rules—they exclude from consideration factors the significance of which was not realized when a rule was promulgated). They also facilitate merging the maker with the applier of the standard—it is often the same entity; namely, the same court.

*Standards: cons.* Similarly, the advantages of rules show up on the other side of the ledger as the disadvantages of standards. They are vague, costly to administer because open-ended, and difficult to monitor compliance with by the court or other body that enforces the standard. The more courts are distrusted, whether because of suspected corruption, incompetence, or a lack of resources for determining facts accurately, the more attractive rules become as the sources of the law applied by the courts. One therefore expects and finds a secular trend toward increased reliance on standards relative to rules.

Notice that despite the association of rules with legislatures and rulemaking with administrative agencies, rules can be judicial (an example is the judge-made rule entitling a criminal suspect to a probable-cause hearing within forty-eight hours of arrest), and standards can be administrative (ex-

amples are police discretion in enforcing speed limits and the use of broad standards such as “unfair labor practice” and “unfair or deceptive acts or practices” by the National Labor Relations Board and the Federal Trade Commission, respectively). Also, standards can be *ex ante*, as in the safety and efficacy standards used by the Food and Drug Administration to decide whether to approve a new drug. And rules can be *ex post*; for example, when a rule is declared by a court for the first time in a case in which the parties did not anticipate it; nevertheless it binds them, as well as others who may have violated the rule before it came into existence. Indeed, judicial rulemaking is characteristically *ex post*.

### 1.2.3 Agencies versus Courts

*Agencies: pros.* Agencies are specialized, and this facilitates the development of expertise in technical subjects (examples are traffic safety departments prescribing speed limits and the Food and Drug Administration regulating pharmaceuticals). They usually have large staffs and flexible powers—often they are authorized to use both *ex ante* and *ex post* regulation. They are less hobbled by precedent than are courts. Agency members have more political legitimacy than judges do because they do not enjoy life tenure, and thus have less need to avoid being thought “activist” and to demonstrate continuity with past political settlements. Judges are reluctant to innovate, or at least to seem to innovate, lest they be accused of crossing the line that separates applying law from making law, the latter considered in orthodox jurisprudence and political theory a legislative rather than a judicial function. Judges are forever denying that they make policy—something that agencies do unapologetically. In fact, the difference is merely one of degree.

*Agencies: cons.* Agencies are subject to far more intense interest-group pressures than courts. The agency heads are political appointees and their work is closely monitored by congressional committees. The fact that agency members are specialized, and that they are less insulated from the political process than judges are, makes them targets for influence by special-interest groups; hence the term “regulatory capture.” Historically, the missions of regulatory agencies have often been anticompetitive, as capture theory implies: interest groups seek to influence agencies to insulate the groups’ members from competition, as by blocking new entry. Execution of valid regulatory policies is often thwarted by the dependence of regulators on information supplied by the regulated entities and by the perverse incentives created by “revolving door” behavior. The large staffs of most regulatory agencies result in the typical agency-cost problems of bureaucracies that are not disciplined by marketplace competition. And regulation is really dual agency-court regulation, because agency rulings are appealable to courts. Regulation can, as in the case of Social Security disability benefits, beget four tiers of adjudication: in the Social Security case they are an administra-

tive law judge in the Social Security Administration, review by an appellate body within the Administration, further review by a federal district court, and appeal from that court to a federal court of appeals. There are no economies from such multitiered regulation.

*Courts: pros.* Courts are relatively immune to interest-group pressures (at least federal courts, whose judges have secure tenure, and some state courts), nonbureaucratic, decentralized, and semiprivatized (because of the major role played by the litigants' lawyers). They bring to the table an outsider's perspective on issues that regulators, afflicted with tunnel vision, might botch. Judges are also less mission-oriented than regulators. Being generalists, and coming from diverse professional as well as personal backgrounds, they are less likely to identify with particular policies and therefore bring a more balanced approach to issues than regulators committed to a particular policy do. If an agency were established to eradicate drug trafficking, and was given the authority to try violators of the drug laws, it would give short shrift to procedural safeguards for accused violators. Federal judges have greater prestige, better working conditions, better salary and (particularly) benefits, more job security, and far more autonomy (in particular, insulation from political and interest-group pressures) than regulators, and all these advantages result in a higher average quality of judicial than of regulatory appointees.

*Courts: cons.* Judges in the Anglo-American judicial systems are among the last generalists in an increasingly specialized government and society, and this is a source of weakness as well as of strength. The judges' lack of specialized knowledge, their limited staffs, limited investigatory resources, cumbersome and to a degree antiquated procedures, commitment to incremental rulemaking, and delay in responding to serious social problems—courts cannot act until a case is brought, which often is long after the activity giving rise to the case began—are impediments to effective regulation, especially of technical subjects. These problems are aggravated by the heavy use—idiosyncratic by world standards—of juries in civil cases. When technical issues are committed to courts, such as issues concerning medical malpractice, product-design defects, and patents on drugs or software, the results often are unsatisfactory. The costly practice of “defensive medicine,” a response to the threat of malpractice liability, is an example of costs resulting from the commitment of technical issues to generalist judges and jurors bound to make many errors. But it is unclear whether the costs of defensive medicine outweigh the benefits of tort liability in creating increased incentives to exercise care in medical treatment. And the poor performance of the Patent and Trademark Office *and* of the semispecialized Court of Appeals for the Federal Circuit (which has a monopoly of patent appeals), suggests that specialization of courts or agencies is no panacea even in highly technical fields.

#### 1.2.4 Public versus Private Enforcement Mechanisms

The common law litigation system, as indeed any private-law system, depends on private individuals and firms to activate the system. The award of monetary damages as the standard outcome of a successful private suit provides the incentive for a private party to sue. The common objection that because of the expense of litigation, victims of small harms (though they may be great harms when cumulated over all victims) is overcome or at least diluted by the class-action device, which allows the aggregation of small claims to create a prospective damages award large enough to motivate a suit. Penalties of various sorts can also be annexed to compensatory damages in order to increase the private motivation to sue.

Nevertheless, litigation is very costly in the United States, and quite slow as well; and the existence of criminal laws is proof (if any is needed) that damages awards (or injunctions, the other common remedy awarded to a plaintiff who prevails in a private suit) are not always an adequate device for controlling behavior. Limited liability (shareholders generally are not personally liable for the debts, including debts created by legal judgments, of their corporation) and liability insurance blunt the deterrent effect of damages liability; and the criminal law, because of the procedural protections that it accords defendants, has limited applicability to negligent or otherwise undesirable business behavior. Hence the creation of regulatory mechanisms that do not require recourse to litigation, although judicial review of the result of the regulatory proceeding is typically available. The rise of the federal administrative agency, which began with the creation of the Interstate Commerce Commission in 1887, reflected a desire to increase the role of expert knowledge in regulation and to counteract what was widely and to a degree correctly believed to be stubborn judicial resistance to modern social-welfare policies. But it also reflected a desire to provide cheaper and more expeditious remedies for perceived wrongs administered by civil servants. Gained was a degree of expertise, expedition, and procedural and remedial flexibility; lost was the superior ability of most judges (at least federal judges) to agency administrators, their greater sensitivity to rule-of-law values, and the energy and initiative of private persons and firms affected by regulation.

The 1970s saw the beginning of a bipartisan deregulation movement that continued until the financial collapse of 2008 and resulted in a substantial curtailment of federal regulation, including the abolition of some regulatory agencies, such as the Interstate Commerce Commission and the Civil Aeronautics Board, and the shrinkage (sometimes by Congress, sometimes by the agencies themselves) in the scope and powers of other regulatory agencies. The fields affected included air and surface transportation (including pipelines), natural gas, wholesale electricity, telecommunications, broadcasting,

and banking and finance generally, including securities regulation. But the deregulation movement (which crashed along with the financial crash) did not reflect a preference for courts over agencies, or indeed institutional considerations at all, but rather a shift in economic policy in favor of competition over both administrative and judicial regulation, a shift that influenced the courts as well in such fields as antitrust and securities regulation.

Moreover, the deregulation movement was limited to commercial competition, and coincided with increased regulation of employment (with particular emphasis on discrimination), health and safety, and the environment. Neither general dissatisfaction with administrative regulation nor with judicial regulation powered changes in the scope and emphasis of regulation.

### **1.3 Litigation and Regulation in Practice**

#### **1.3.1 Pure versus Mixed (Hybrid) Systems (Corner versus Interior Solutions)**

A pure system of regulation would be only administrative regulation or only litigation; a mixed system combines the two modes of control. There are virtually no pure regulatory systems, because most regulatory decisions by administrative agencies are subject to judicial review. That is a more limited form of judicial intervention than a proceeding that begins in court rather than in an agency, but on the other hand it is common to provide parallel administrative and judicial remedies for the same harms, as in the case of antitrust, where one can bring a suit in federal court or file a complaint with the Federal Trade Commission, which can decide to institute an administrative proceeding, with eventual judicial review. A different kind of dual regulation is found in employment discrimination. A person complaining of discrimination in violation of federal law can file a suit in federal court. Alternatively the Equal Employment Opportunity Commission (EEOC) can file a suit in federal court on the person's behalf; in neither case is that adjudication within the commission itself, unlike the antitrust example.

Nearest to a pure system of administrative regulation is a system in which compliance with a regulatory rule or order precludes a subsequent lawsuit (preemption). The financial industry has the closest approach to a pure regulatory regime. Medical malpractice approaches a pure litigation system, except that there is some regulation of hospital and physical practices, and of course there is licensure of physicians and other health-care providers. Antitrust approaches a pure litigation system too, despite the merger guidelines published by the Department of Justice and the Federal Trade Commission (FTC). The guidelines provide a basis for advance determinations by the agencies whether to approve proposed mergers, but are nonbinding. A paral-

lel is the federal sentencing guidelines, which are administrative guidelines that influence but do not bind federal criminal sentencing.

*Pure: pros.* A pure system is cheaper, simpler, operates much more quickly, and provides better guidance. The need for speed, well illustrated by the response of the Federal Reserve and the Treasury Department to the sudden financial collapse in September 2008, can be a compelling reason for a regulatory system in which courts play little or no role. Thus, while failing firms normally are subject to liquidation or reorganization in a bankruptcy court (part of the federal court system), commercial banks that fail are “resolved” in administrative proceedings by the Federal Deposit Insurance Corporation.

*Pure: cons.* When time is not of the essence, a pure system of administrative regulation has many disadvantages. For one thing, it increases the incentives for, and therefore the likelihood of, regulatory capture by interest groups; the interest group has only to “buy” an agency, and not the courts as well—and the federal courts are very difficult to “buy.” Also, a pure system of either kind (agency or court) sacrifices complementarities, because courts and agencies are complements as well as substitutes. Agency action subject to judicial review melds specialist with generalist perspectives and mission-directed policy with sensitivity to rule-of-law factors.

*Mixed: pros.* A mixed system, as just mentioned, exploits complementarities between agencies and courts. Sentencing judges fine-tune sentencing guidelines; antitrust judges fine-tune Justice Department or FTC merger guidelines; and judges review the rulings of administrative agencies for compliance with statutes and with principles of fair procedure, which are subjects that judges are more familiar with and more scrupulous in giving appropriate weight to than mission-oriented administrators are apt to be. A mixed system is also (as I have suggested) less susceptible to capture by interest groups because in a mixed system the interest group has to “buy” both the agency and the courts. (This is a traditional argument for trial by jury rather than trial by judge: it is harder to bribe twelve “judges” than one.) The mixed system also provides a back-up or fail-safe regulatory capability. In the case of drug safety, for example, when the Food and Drug Administration fails to prevent the sale of an unsafe drug, the tort law of products liability provides an alternative, ex post control over its sale.

More generally, a violation of a regulation might create a calculable injury to particular persons—allowing them to sue for damages provides a remedy tailored to the social cost of the violation. More interesting is the case (illustrated by the example of drug safety in the preceding paragraph) in which the regulation is complied, but with injury results, and it is apparent ex post that the regulation was inadequate. Allowing a suit for damages not only compensates the injured person but also provides an incentive for the persons or firms subject to the regulation to take additional precautions.

*Mixed: cons.* A mixed system conduces to delay and uncertainty of outcomes and imposes costs of duplication.

### 1.3.2 Competitive Regulation

Often more than one agency regulates the same activity. Both the Justice Department and the Federal Trade Commission enforce the federal antitrust laws, and in addition state attorneys general enforce state antitrust laws modeled on the federal laws and applicable to many of the same enterprises. Private suits can also be brought to enforce both the federal and the state antitrust laws. To complicate the picture still further, state attorneys general can bring federal antitrust suits on behalf of their states. Regulatory competition increases the likelihood that a violation will be detected and punished, but also increases compliance costs for the firms subject to the dual or multiple regulatory regime.

“Regulatory arbitrage” refers to the unifying practice of firms’ configuring their businesses in such a way as to bring them within the regulatory jurisdiction of an agency likely to favor the firm, perhaps because the agency is supported by fees of the firms it regulates and therefore, to increase its budget, seeks to entice firms by an implicit promise of light regulation. Thus, a bank might decide to seek a state rather than federal charter because it thought the state banking commissioner would be more tolerant of the bank’s loan policies than a federal banking regulator, and the commissioner might welcome the newcomer because of the effect on the commissioner’s budget of having a new fee-paying “client.”

It is difficult to generalize about the choice between monopoly and competitive regulation. In the case of safety regulation, it is common to allow states to impose stricter safety standards than the federal regulators, although the federal regulation will invariably be deemed to preempt state regulation that contradicts the federal so that, if applicable, it would impose inconsistent duties on the regulated firms.

A competitive system should not be confused with a mixed (regulation plus litigation) system. In the mixed system, the different regulators (administrative agency and court) are stacked vertically; the parallel in business is to the hierarchy in a firm. In a competitive system, two agencies (or two judiciaries) may find themselves empowered to regulate the same activity, and the hope is that the competitive setting will keep each one on its toes.

Competition among federal agencies, as in the banking and antitrust areas, is rare. Regulatory competition primarily involves overlapping federal and state jurisdiction, and the primary reason for this competition is simply the constitutional status of the states. They are not merely bureaucratic subdivisions of the national government but instead quasi-sovereignties that make and administer their own laws until Congress or the federal courts intervene to prevent actual conflicts with federal law.

### 1.3.3 Comparative Analysis

There are significant differences in regulatory institutions and procedures across countries and also across states of the United States and between federal and state governments. For example, civil-law courts are much like U.S. regulatory agencies (bureaucratic, rule-bound), and state courts are on average more politicized than federal courts. In general, rules are more important, and standards less important, in civil-law than common-law countries. Hence, mixed systems in civil-law countries are likely to involve fewer agency-court complementarities than in common-law countries.

## 1.4 Reforming Existing Regulatory Regimes: Transition Costs

Suppose some new area of activity is sought to be brought under regulation; or there is dissatisfaction with the scope or implementation of an existing regulatory system. The choice is often between seeking to reform the existing system or creating a new system. In the usual case this comes down to a choice between tinkering with an existing agency (its powers, resources, leadership, or staff) and creating a new agency.

*Tinkering with the existing agency: pros.* This has the advantage of speed, economy, avoiding turf warfare (the creation of a new agency is likely to step on bureaucratic toes by taking powers from or competing with other agencies), and avoiding an increase in the complexity of government. Also, it is easier to rescind changes in an existing agency, if they prove unsound, than to abolish an entire agency, which will have developed a constituency in Congress or among interest groups.

*Tinkering with the existing agency: cons.* Agency staff, having civil service protection against being fired, may be bold in resisting change and may resist it effectively, with assistance from members of Congress and interest groups. Giving an agency new responsibilities may reduce its ability to perform its old responsibilities and create tension between staff assigned to old responsibilities and staff assigned to the new ones. Seniority considerations may give “old timers” significant positions in administering new programs with which they are unsympathetic.

*Creating a new agency: pros.* Creating a new agency is a strong signal of a new departure and may attract committed leaders and staff from outside the existing governmental bureaucracy. Exclusively committed to the new programs that gave rise to the new agency, leaders and staff will be judged by the success of the programs and will not be able to bury them in a bureaucracy that has many other programs and constituencies to attend to.

*Creating a new agency: cons.* These are the converse of the pros of tinkering with an existing agency. Creation of the agency will be time-consuming and involve struggle with existing agencies and their backers in both Con-



gress and industry, will be difficult to reverse, and will increase the complexity of government.

### **1.5 Conclusion**

The costs and benefits of the different control institutions and techniques have changed over time. The optimal and actual mixture has therefore changed. For example, diseconomies of scale in litigation (a court system is pyramid-shaped to maintain uniformity, and if there is too much litigation too many layers of review are required, creating unacceptable delay and confusion) may require the creation of regulatory alternatives to litigation. And the rise of public finance as a consequence of more efficient methods of taxation has made regulation, which is more costly to the government than litigation (largely financed by the litigants themselves), more feasible. Rising information costs because of greater technological complexity may also increase the gain to expertise and hence the comparative advantage of specialized agencies relative to generalist courts.