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RESEARCH PAPER

# The justifications for the regulation

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**Abstract**

The classical economists have mostly focused their attention on the functioning of the market and not on the role of the State. The analyses of various democracies are based on the assumption that the State decisions once made are applied as intended by the authorities who are responsible for their practical implementation. The economics of regulation is situated at the intersection of the public economics and industrial economics, it explores different forms of government intervention in industrial activities to simulate either to control or even to reprove them. Public intervention can take different forms: in Europe the most common practice is the nationalization, it is the public monopoly of law. In the United States operation of this natural monopoly is assured through economic regulation, that is to say all means by which Governments directly influence the activity of companies while maintaining the framework of the private property. It is very important to distinguish between the economic regulation of an activity that focuses on the price and the determination of the structure of offer, and the social regulation concerning the conditions for the exercise in the activity and the physical characteristics of the products or services (protection of workers in their working conditions (health, security), rules of environmental protection or standardization of products (quality).

**Key words**: market, lobby, regulation, optimum, rent seeking, Government

## Introduction

The justification of the public interest in violation of individual preferences can be incorporated into a normative individualist approach to the public economy according to two lines of argument: either by problems of distortion of preferences or a character of external effects.

*Problems of preferences distortion*

Some economists as Bergson and Musgrave (1989) admit that other reasons than those associated with market failures warrant normative recommendations, which although based on individual values, diverge from individual preferences. For this, they make a distinction between preferences, satisfaction and well-being. According to Head (1966), individual welfare must be the basis of allocation norms and not the preferences actually revealed on the market. The preferences may indeed be distorted by two types of influence:

Individual preferences for a large number of goods are the result of a certain ignorance or incomplete information; in this case, public intervention by means of fiscal measures or regulations aimed at correcting for example tendentious information should make it possible to produce choices that individuals themselves would be able to recognize as superior.

There are differences between an individual's preferences and well-being following the irrationality of choices. Intervention justified by irrationality can be reconciled with the normative model when consumers voluntarily give up their sovereignty to certain types of choice (foreign policy, for example), but here the correction of the preferences judged by certain irrationals implies a tendency to authoritarianism that can hardly be reconciled with a normative model based on consumer sovereignty.

**Externality of good under tutorship**

The notion of goods under tutorship makes it possible to introduce the specific motivations of the public authorities. When the State makes a choice in its own name, it finds itself in flagrant contradiction with the principle of neutrality with regard to individual preferences. Goods under tutorship are goods whose consumption and / or production are the subject of State concern, that is, preferences of the State which are different from those freely expressed by individuals.

The term goods under tutorship introduced by G, TERNY (1971) covers much of what R. said. MUSGRAVE in 1959.

MUSGRAVE called them " Merit Goods ", in fact it distinguishes between collective and tutelary goods, whereas for public goods the State is content to take decisions as close as possible to those taken if the preferences individuals were revealed on the market, and consumer sovereignty was respected, while guardianship did not satisfy this condition of sovereignty. The public authority plays a role of tutorship of the consumers: it uses its power of coercion in order to impose on individual's choices which it considers good for them; they are only satisfied by the state because they are considered particularly important. The state sets itself as tutor of the other agents by deciding according to his own preferences. This supervision may concern private goods such as public goods in the sense of PA SAMUELSON (2005). With respect to private goods, it manifests itself either by distorting their market prices or by subjecting their production or consumption to physical constraints, even by directly ensuring their production which then becomes public non-market managed by the state. With respect to collective goods, tutorship is most often manifested by taking charge of their production (non-market public goods) and sometimes by taxation (semi-commercial public goods) so that they are no longer the collective concerns of individuals but those of the state that guide this production.

According to Bénard, state concerns have just interfered with the individual or collective concerns of individuals. In general the tutelage translating behaviour in front of the State because it is based on preferences a priori foreign to those of the individuals composing the collectively, and goes at best only to lead to an optimum second rank.

There are, however, cases where the tutelage brings the equilibrium back to the optimum of first rank in the case where it corrects the effects of the factors of rupture of correspondence between market equilibrium and paretian optimum: imperfection of its competition of natural monopoly with increasing returns, these are externalities. We can then speak of corrective supervision; it is the example of the public monopoly - the increasing yield - which is obliged to fix its prices at the Marginal Cost and whose resulting deficit is financed by lump-sum transfers taxed by the State is another ex of corrective supervision.

**Reasons for placing tutorship**

The justification of public intervention in violation of individual preferences can be integrated into a normative individualistic approach of the public economy according to two lines of argumentation:

Assets under tutorship would be marked at the same time

1. by problems of distortion of preferences.
2. by an external effects character

There is a discrepancy between preferences and individual well-being. The preferences expressed by individuals in the markets may in some cases not effectively ensure the maximization of their own well-being; this approach has been controversial:

Some economists such as Bergson or Head (who follow Musgrave) admit that reasons other than those associated with market failures justify normative recommendations that, although based on individual values, diverge from individual preferences; for this they distinguish between preferences, satisfaction and well-being.

Head (1969) has established that individual well-being must be the basis of the allocation standards and not the preferences actually revealed on the market; preferences can indeed be distorted by two types of influence:

Individual preferences for a large number of goods are the result of ignorance or incomplete information (product complexity, frequency of purchase, product advertising). In this case, public intervention by means of fiscal measures or regulations aimed at correcting, for example, biased information should make it possible to produce choices that individuals themselves would be able to recognize as superior, ie more in line with their real preferences; thus remains linked to the sovereignty of consumers. According to Bénard this is one of the reasons to compensate for the insufficiencies of information of individuals who are supposed to ignore the most effective way of satisfying their own needs: hence the obligation of consumption (compulsory education, vaccinations) or prohibitions (alcohol drugs); speed on roads. Some goods may be placed under guardianship for their merits when it is considered that individuals are not willing to allocate sufficient resources of their own choice (education, compulsory insurance) or by their demerits when reproaching individuals to abuse of their consumption (alcohol drug). According to Bénard, the state does not consider itself authorized to thwart individual preferences, the public authorities will intervene in household consumption programs and in prices and incomes only if they are better informed than the interested parties themselves. The effects of certain cons on the satisfaction of the individuals in question.

There are thus divergences between the preferences and the well-being of an individual which are consecutive to the "irrationality of the choices." Intervention justified by irrationality can be reconciled with the normative model when the consumers voluntarily give up to the government their sovereignty for certain types of choice (foreign policy for example), but here the correction of the preferences judged by certain irrational agents implies a tendency towards authoritarianism which can hardly be reconciled with a normative model based on the sovereignty of consumers.

Mc Lure (1968), on the other hand, argues that Musgrave-defined trust properties have no place in a normative theory of the public sector that is based on the satisfaction of individual preferences; or what Musgrave means by trusteeship is a common good or an objective whose distribution does not require a violation of preferences; or they interfere with individual sovereignty and therefore have nothing to do in a system where the norm is precisely based on these preferences.

Goods under tutorship can be explained by the presence of important external effects (eg, drugs).For Mc Lure (1994), these are internalized externalities and it is not necessary to use a new term to designate the compensation or intervention system operated by the public authorities to ensure the optimal allocation of resources in the event of externalities.

According to Benard (1985) regulations mainly concerned two forms of market and firms: increasing returns sector and natural monopoly and those non-increasing returns where distributional concerns (social) cause protectionist regulations. According to Pondaven (1998) regulations can be analyzed in terms of three paradigms: economic efficiency, equity, political efficacy.

**The equity phenomenon according to the Pareto criterion**

According to Pareto the criterion of equities is necessary but it is not enough.

- The necessary aspect

the Pareto optimum rightly states that it is necessary to capture all the shortfalls that may exist at a given moment in the allocation of resources and this point is indeed not debatable.

a government that does not seek to be in this situation would be in conflict with the unanimous agreement of all agents; the paretian goal can therefore be common to all economic policies whatever their foundations; this is one of the reasons for the importance of this concept in the public economy. Every member of the community has a veto right. In other words, this criterion corresponds to the unanimous voting rule; but unanimity is understood here in the sense of "person against" and not of "everyone for"; This characteristic makes the paretian criterion easily acceptable to all. The concept of optimum reflects an idea of absence of waste; but it does not define a unique situation: infinity of different resource allocation solutions can satisfy the optimal allocation conditions.

- The insufficient aspect

On the other hand, the Pareto criterion refuses to judge between all the situations where the welfare of one individual can be improved only to the detriment of the welfare of another. Many optimal solutions from the point of view of allocation are unacceptable from the point of view of distributive justice.

Pareto: focuses on the possibility of improving the well-being of at least one person but excludes the possibility of a decrease in the welfare of any other person; he thus succeeds in avoiding the interpersonal comparisons of utility upon which one is necessarily bound when it comes to appreciating the desirability of a policy. Pareto: focuses on the possibility of improving the well-being of at least one person but excluding the possibility of a decrease in the well-being of any other person; he thus succeeds in avoiding the interpersonal comparisons of utility upon which one is necessarily bound when it comes to appreciating the desirability of a policy. The Pareto criterion prohibits interpersonal comparisons of utility (it is based on an ordinal conception of utility). This inability to make interpersonal comparisons of utility results in the impossibility of judging a reallocation that would improve the utility of at least one individual by impairing that of at least one other.

Some distributions of wealth can be particularly unfair in terms of equity. For example, if according to an initial allocation, an individual A has everything and an individual B has nothing: the Pareto criterion shows that it is impossible to change the situation by improving the situation of B without damaging that of A. It is not possible to determine according to the Pareto criterion which allocation is socially optimal.

The paretian criterion only defines a partial order on all the allowable allocations. In other words, it is not possible to classify all the allowable allocations. The welfare of the paretian welfare does not therefore allow defining a partial order on allowable benefits. It is not always possible to say when one allocation is better than another. The problem is particularly serious when one thinks of concrete cases of State intervention about which one would like to know whether or not they are normally justified. There is almost necessarily. Every time winners and losers and a strict application of the Pareto criterion would, in practice, render the economist incapable of recommending anything. Let us repeat here, because the error is frequent, that the paretian economy by declaring itself incompetent with the changes of this type does not condemn them and that the paretian criterion cannot be accused of being exceptionally "conservative". To get out of this indeterminacy (and to allow economists to assert their social utility in a more convincing way, two types of solution were considered:

The first solution is to explicitly consider a new value judgment in all cases where the Pareto criterion is not sufficient. This standard of evaluation will necessarily be foreign to the welfare of the paretian welfare, but ideally, for the sake of consistency, it should not be incompatible with it. As it is a question of comparing between them allocations which are distinguished by the respective levels of utility of the individuals concerned and that the concern for equity is characterized precisely by a particular attention to the distribution (of the utilities, in this case), it is natural to appeal to what is commonly referred to as the theory of justice. The second solution is that of the hypothetical "compensatory compensation" (or compensation) suggested in slightly different forms by Kaldor and Hicks 1981.

It must then be judged to what extent the decline in utility of one individual can be offset by the increase in utility of another individual. An approach that is at the root of the cost-benefit analysis that attempts to assess collective well-being from individual assessments and their summation; the starting point of the measurement of the improvement of the collective well-being is then the surplus of the consumer used for example to compare alternative projects.

**Regulation and equity**

We can imagine that, the redistributive objective of the State is rather to ensure to all the possibility of consuming a given minimum quantity of a certain number of goods considered "essential": food, health, housing, education. In this perspective, the State could intervene to subsidize precisely these goods so that the desired minimum is actually achieved. This argument put forward by Tobin (1970) corresponds to the so-called doctrine of specific egalitarianism.

Remember that the Pareto optimum is defined for a given distribution revenues, for each distribution of wealth correspond an economic optimum, and the state may intervene to redistribute wealth according to its conception of equity.

Income redistribution can be studied from two different angles:

- In terms of regulation undertaken to satisfy a condition of fairness.
- In terms of taxation to define the optimal sharing rules (tax burden).

We see that the first appearance here the fair regulations ,i.e., equitable is one that satisfies certain arbitration rules between consumer interests and the interests of producers subject to the conditions of taxation, the properties of such rules have been defined by (Lee 1980).

A regulation arbitrating fairly between the respective interests of consumers and producers checks three properties:

- It is favorable to both consumers and producers of the regulated good.
- It implies the absence of liquid transfer from consumers to producers.
- The tutor is fair i.e. equitable in pricing.

Conditions for equitable arbitration are provided by the tutor arbitrator. Regulation must be seen as a process of exchange relating producers and consumers and incorporating the State as referee. Fair regulation is not necessarily egalitarian, equitable justice is simply a profitable justice to all without condition on gain sharing, between all, some may earn more than others, but each group of agents necessarily takes a interest in, regulation just:

— Producers get permission to maintain their cartel; in exchange they give price benefits to consumer, however prices remain higher than those of competitors.

— Thus Consumers are beyond to the cartel prices, and draw an advantage.

Regulated prices which are acceptable for both groups of agents of contradictory interests are included in the profitable prices of cartel producers and satisfactory price competition for consumers. Lee’s solution determines the fair price defined as the price which ensures a distribution of wealth and a fair allocation of resources.

The suitable regulation involves preferential prices (or social preferential price), these prices have the advantage of keep unchanged respectively consumer and producer surplus, these two prices are called first price and second price determine the boundaries of lower price upper and imposed by the referee. To ensure that the regulation benefits to producers and consumers, it must establish an intermediate price between those two.

**Regulation and policy effectiveness**

Normative theory of social welfare based on the paradigm of Paretian economic efficiency, leaves no chance, to pressure groups which play a crucial role in the implementation of the management and elimination of economic regulations. That’s why appears the literature using the theory of public choice in the behavior of men and Governments. The ability to attract government regulations, encourage some people to be in lobbies seeking for approaches rents, and participate in the refutation of the regulations.

Bruce (1984), it indicates that it is possible to correct the two main market failures, its inefficiency and inequity, without forcing a pure and simple abandonment of the market and private property system.

Away from concern for the collective interest, regulation involved in rent seeking strategies that favor some at the expense of others and all; public choice theorists have initiated Stigler’s approach regulation based on the logic of political bargaining between the government and a majority of reduced size winners .The conditions of success of such negotiations are formalized by Peltzman (1976) giving in his model (Political support 1976). This model is rooted in capture theory (Stigler 1975).Stigler extends the works of Tullock (1967), who argued that firms are willing to devote significant resources to bring those responsible for decisions to adopt rules ensuring their protection. The initial findings of Stigler remain fairly pessimistic about the role of regulation as correcting market failures. The Misallocation of resources due to attempts to create situation rents can have worse effects than those who come from the monopoly power or other market failures which could justify the introduction of a regulation.

According to Stigler : we have mainly use regulations to protect firms which are already on the market entry of potential competitors: Politicians can vote a regulation approach not to meet an abstract public interest, but to benefit from the potential political impact of the operation. Interest groups who have the most chance to gain from regulation are those who are willing to invest more resources to get the support of politicians, so the regulated firms are often able to obtain the regulation which complies with their wishes.

The originality of Stigler’s analysis is to bring regulation to a problem of bargaining between the tutor offers or of services and citizen guarantees of political support in exchange for protections acquired; the regulation is therefore reduced to finding an optimal size of favorable votes. For ensuring a sufficient political support, the tutor must guarantee to its supporters payment transfers; transfers verify a diminishing returns depending on the size of the beneficiary group. The costs of running campaigns of political support not only limit the size of the dominant group but also their gains ; and the low number of winners helps to facilitate consistency of their requirements and negotiations with the tutor, So it is the low number of winners who is important than their electoral weight. This theory is called a theory of capture or predation, as soon as regulated agents are able to turn to their advantage to regulation during successive bargaining with the tutor. The number of partners and their influence are crucial and determine the sharing winner's losers; the number of winners should not be too high for the gain per head and will be sufficient to ensure their political support.

On the other hand, the number of victims (losers) should be high in order to effectively disseminate the per capita cost of regulations. The first objective of the regulation according to the theory of predation is not the search for an optimum, but to obtain monopolies satisfactory efficiency without abandoning too high rents to the various partners. The necessary and sufficient conditions for the optimal size of the group winners are presented by Peltzman.

According to the Peltzman model, "optimum political support formalizes the economic theory of regulation of particular interest, and all the operating costs of the campaigns of support slow down the size of the group dominating but imposing also a maximum threshold for the distribution of transfers. “The particular interest of the tutor is represented by its authority to control and tax the votes of citizens; a favorable voter receives a subsidy, the opposition members are penalized by a tax to finance the transfer allocated to the winners, the search of political support is equivalent to setting the optimal political majority.

This model is a negative sum game even though transfers to winners are fully financed by taxes levied on the losers. Regulation deviates from the Paretian solution and thus generates a deadweight loss. Regulated prices are indeed different from optimal competitive prices and adversely affect economic efficiency, that’s why we can say the game is to sum zero.

Expenditure persuasion can help the tutor to reduce the opponents by taxing different losers differently, thus the opposition can be reduced; Peltzman defines the conditions for minimizing the opposition by distinguishing two groups of losers. The view of Stigler was supported by Peltzman (1976), according to him: railways were regulated under the pressure of railway companies themselves. The simplest theory developed by Posner, who gets the theme of regulatory capture by lobbies. Peltzman precise this thesis by analyzing the differences between optimal and actual regulation depending on the nature of the political support received by the government. Peltzman’s model (1976) considers regulation which aims pricing to improve the economic situation of a particular group (beneficiaries) to the detriment of the rest of the population. Transfer received by beneficiaries is paid by a premium price (relative to competitive levels) or a tax on the victims. Beneficiaries will often be producers and victims will be consumers (final or intermediate).It does not mean a zero-sum game, since any price distortion compared to the competitive equilibrium leads to social efficiency loss, so it is a negative sum game.

Beneficiaries and the victims are the citizens whose authority seeks to maximize their maximum votes, since in democratic regime its survival depends on them. Thus the government will therefore determine its regulatory policy to attract maximum favorable votes of voice beneficiaries or part of victims of this policy. The main result is to show that difficulty into vote’s transfers representing advantage for beneficiaries and taxes for the victims led authorities to concentrate benefits on a small number of beneficiaries. The same reason leads symmetrically to disseminate losses represented for example by taxes on a large number of victims and the beneficiaries will be more keenly aware of their advantages and victims bear their losses more painless. This economic reasoning reinforces the sociological observations that show a very small count protest beneficiaries are eloquent and well organized support the weight of their benefits to a large number of silent and unorganized victims.

**Conclusion**

The last subprime mortgage crisis in the United States, affecting the subprime mortgage industry, shook the world. The crisis spread to the world as a whole, in a context of contagion to all economic actors. This crisis reminded us that the market economy cannot function without crises. This requires the intervention and periodic control of the state. Therefore, the state has an important role to play in preventing crises and boosting economies after financial catastrophes like the subprime crisis.

The substitution of economic criteria by political criteria in process of setting prices explains the permanent tendency of regulation to encourage cross-subsidies in the form of equalization of prices where consumers facing high costs are subsidized by those low cost whose income is thus redistributed.

This incentive to tax or to subsidize all consumers because of the special characteristics of some has consequences on the structure of regulated prices. This system is antithetical to the profit maximization since it subsidize unprofitable activities (or consumption of high cost) more profitable activities (or consumption of low cost). These phenomena are explained by political and sociological pressures but also on the model of Peltzman.

Maintaining constant demand, consumption to high cost will receive price/consumption reports below. Their high costs will be distributed among all consumers by a rational policy to maximize political support.

The interventions of lobbies in establishing a price or quantitative regulation manifested by political pressures but also supplies economic information to defend their case and persuade the tutor for their favor. The idea is that the market does not fully satisfactory manner especially in connection with the structure of the sector and is not with the nature of the goods.

In view of the foregoing, it is important to emphasize that state intervention in the economy is indispensable in the face of deficiencies and the unsatisfactory functioning of the market, especially in the liberal systems of capitalism. By the norms that he has to enact and by regulation and the redistribution of wealth he is obliged to act on the economy. However, the State must intervene in certain circumstances to restore balance and safeguard the social order.

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