1. Introduction

Self-regulation, understood narrowly as law formulated by private agencies to govern professional and trading activities, has been rigorously criticised by lawyers and economists alike. From a legal perspective, it is seen as an example of modern “corporatism”, the acquisition of power by groups which are not accountable to the body politic through the conventional constitutional channels (Schmitter, 1985). The capacity of such groups to make rules governing the activities of members of an association or profession may itself constitute an abuse if they lack democratic legitimacy (Page, 1986). The potential for abuse may become intolerable if, and to the extent that, the rules affect third parties (Cane, 1987). Further, if the group’s functions cover policy formulation, interpretation of the rules, adjudication and enforcement (including the imposition of sanctions) as well as rule making, this conflicts with basic notions of separation of powers (Harden and Lewis, 1986). For their part, economists have traditionally focused on how self-regulatory powers may be exercised to impede competition on the supply side of the market. Barriers to entry may be created, thereby raising prices and conferring rents on incumbent practitioners; standards governing practice may be devised more to confer utility on suppliers than to meet consumer preferences (Shaked and Sutton, 1981a). And the prospect of gaining such advantages may lure groups into spending resources to persuade legislatures to grant them self-regulatory powers – a social deadweight loss (Tullock, 1967).

While criticisms such as these may be appropriate in some circumstances, they are based on a very incomplete picture of self-regulation. The modern law and economics literature has been concerned to explore a much broader conception of the phenomenon and in so doing to identify institutional arrangements which may escape, or meet, the traditional criticisms and which thereby may be conducive to allocatively efficient outcomes. A survey of this literature must necessarily begin with an investigation of the nature of self-regulation.

2. The Nature of Self-Regulation

In its most literal sense, and as used in psychology (Carver and Scheier, 1981), self-regulation means acting according to one’s own volition, and not as a
response to an external constraint. Thus interpreted, the concept would cover an infinite number of self-imposed behavioural standards, including those determined internally by the management of a firm. Although the latter may have no legal significance, they are not irrelevant to discussions of regulatory systems (Bardach and Kagan, 1982; Cheit, 1990). The internal standards are designed to ensure quality of the kind which will meet consumer preferences.

On the assumptions of competition between suppliers, adequate information possessed by consumers and an absence of externalities, there is no need to render the standards legally enforceable.

When used in a legal context, the “self” in “self-regulation” is not used in the literal sense. Rather it connotes some degree of collective constraint, other than that directly emanating from government, to engender outcomes which would not be reached by individual market behaviour alone (Black, 1996). It is also normally taken to imply “a fairly well established and generally recognised set of rules, whether customary or reduced to writing, in accordance with which the activity is regulated” (Cane, 1987).

There is, nevertheless, a multitude of institutional arrangements which fall somewhere between government regulation on the one hand and individual, unconstrained behaviour on the other and which can therefore be treated as self-regulation (Rees, 1988; Cheit, 1990). The possibilities can be considered on two spectra depicting, respectively, degrees of autonomy from government and legal force (Page, 1986; Baggott, 1989). The first ranges from, at one extreme, rules private to firms, groups or organisations to, at the other, those approved by a government minister or some independent public authority; in between, representatives of the public interest may participate in, but not conclusively determine, the decision-making. The second encompasses varying degrees of legal force. The rules may be: formally binding, non-compliance leading to public law or private law sanctions; codes of practice which presumptively apply unless an alleged offender can show that some alternative conduct was capable of satisfactorily meeting the regulatory goals; norms the breach of which leads to non-legal sanctions, such as ostracism; or standards, compliance with which is purely voluntary.

In recent years, self-regulation has increasingly been regarded as a means of improving regulation, by both national governments and international organisations, like the EU and the OECD (Hutter, 2001; OECD, 2002). Self-regulation might help ease the burden of state regulation and (it will be argued later) may be more efficient, since it can make better use of local information and has more effective instruments to guarantee enforcement. This poses the crucial issue of the optimal relationship between centralised (or government) regulation and self-regulation. The distinction between centralised and self-regulation is not so clear cut, since many schemes based on self-regulation imply some kind of control by the government (Ogus, 1995; Black, 1996).
Moreover, self-regulation is often regarded as problematic, since the divergence between public interest and the objectives of the self-regulating entities may entail a pro-regulatee bias (see Section 4). Bartle and Vass (2007) suggest that the correct relationship between government and self-regulation should be based on a subsidiarity principle, implying that regulation should be made at the closest possible level to the regulatee, as long as the gains from decentralisation outweigh the cost of the pro-regulatee bias. Such process of deregulation should however be “embedded” within the regulatory state, which would scrutinise the outcomes of the self-regulatory process and guarantee that the procedures adopted by the self-regulated entity are not contrary to the public interest (Moran, 2003, gives an account of self-regulation along state-controlled lines in the UK).

In the remainder of the chapter we will analyse self-regulation from this perspective, paying special attention to the costs and benefits of delegated regulation. However, before that, we need to discuss the purest form of self-regulation, which occurs in the complete absence of any form of state intervention.

3. Spontaneous Private Legal Ordering

In its most complete sense, and thus at one end of the spectra described above, self-regulation involves a system of private ordering, without any form of state intervention; that is, without any imposition of rules by those with political power. Systems of private ordering are the basis for phenomena of spontaneous emergence of law and are sustained by extra-legal (or social) sanctions. We will not deal with spontaneous emergence of law, as this would be beyond the scope of the chapter. For a valuable overview of the literature, see Klein (1997).

Economic explanations of how informal systems emerge are epitomised by studies of primitive societies (Benson, 1988). The basis is reciprocity: individuals recognise the benefits they will derive from behaving in accordance with others’ expectations. Such reciprocity may be reflected in individual agreements, but, as standards of behaviour, will spread to other members of a group as property rights when the benefits of doing so exceed the costs of defining those rights. While originally disputes may be resolved by force, individuals will normally find non-violent methods (for example, arbitration or mediation) to be cheaper; and ostracism from the group will generally be an adequate sanction for non-compliance.

Analysis of this kind has been used to explain other historical self-ordering arrangements, including: the Maghribi Traders (Greif, 1989); the Law Merchant (Benson, 1989; Milgrom, North and Weingast, 1990); medieval Iceland (Friedman, 1979); and the mining camps in the American West (Anderson and Hill, 1979; Umbeck, 1981). In more modern contexts, equivalent systems can emerge within groups to reduce the costs of drafting commitments and of establishing and activating enforcement systems (Charny, 1990).
Self-regulation

expectation is that such cost savings will be significant where the group is small enough for informal control – generally requiring continuing face-to-face interaction – but where also power is broadly dispersed (Ellickson, 1993). Illustrative studies are those on diamond traders (Bernstein, 1992) and neighbour disputes (Ellickson, 1991).

Within a broader social setting decentralised law-making encounters the problem that some individuals will tend to free-ride on the enforcement of others. This may be only partly solved by the internalisation of norms, and thus public institutions (courts) are necessary to identify situations requiring state-imposed incentives (Cooter, 1996). Nevertheless, informal systems also occur in international trading environments (Benson, 1992; see also Schanze, 1988).

Here there is an increased need to accommodate the system to inter-group interaction. The co-existence of groups creates incentives for each to compete to attract or hold members and a form of mutual insurance emerges to prevent individuals taking advantage of other individuals and then escaping to another group (Benson, 1993).

A not insignificant part of the literature addresses the normative issue of choice between public and private ordering. Some (for example, Friedman, 1973; Rothbard, 1973; Benson, 1990) reveal a hostility to almost all instances of state-imposed law, arguing from public choice theory that it is predominantly motivated by pressure for wealth transfers and undermines the incentives of the reciprocity-based system of property rights. But, apart from the important reminder that the consequences of government failure may be more severe than market failure, it is not clear that these contributions add much to the debate which has taken place within the mainstream of law and economics (Katz, 1996), and which has its origin in the Coase Theorem (Coase, 1960). The ability of consensual bargaining to achieve efficient outcomes is a function of transactions costs, thus suggesting that the normative question of when private ordering should prevail should be determined by an analysis of how those costs impact on any given situation. Self-regulation may, therefore, be an appropriate solution where bargaining, at low cost, can occur between risk-creators and those affected; occupational health and safety provides a familiar example (Rees, 1988; Ogus, 1995; though for reservations, see Baldwin, 1987).

Much of the older literature on spontaneous order, surveyed above, is based on the implicit assumption that private (informal) legal systems emerge spontaneously, in response to the need to fill some regulatory void. However, such a view misses a crucial evolutionary issue.

Private legal systems are characterised by network effects: the benefits from membership increase with the number of participants. Such benefits are therefore likely to be limited in the early stages of the formation of the new network. Enforcement, on the other hand, is very costly. It is therefore difficult
for newly formed private legal systems to assure compliance with the rules. With lack of enforcement, free-riding is possibly very frequent, where members enjoy the benefits from the network but then cheat on the rules. Individuals would then hardly be motivated to join the network in the first place, and the private legal system may not form. This is the “paradox of spontaneous formation” (Aviram, 2003 and 2004). Such paradox can be overcome by finding ways to exploit an existing network, with a functioning enforcement system, building the new private legal system on it. This would explain why many spontaneous institutions rely on the enforcement power of religious networks, to evolve into private legal systems joined by the vast majority of a social group. This is a fascinating theory, supported by prominent historical examples. Like all “chicken and egg” problems, however, it fails to explain how the first enforcing institution developed, the one that allowed, in a chain effect, all other social institutions to establish themselves.

The analysis in Buskens (2002) provides a possible response to such a paradox. He studies trust relationships in social networks, finding that trustworthiness is influenced by “the social context”. The social context registers and publicises information regarding the past behaviour of members of the social group. It also offers the possibility of sanctioning free-riding and cheating through second- and third-party sanctions. Given that interaction in social groups is typically repeated in time, sanctions have not only the immediate benefit of reducing the incentives to cheat for current cheaters, but they also signal to future wrongdoers that the threat of punishment is credible. That is why third parties, who are not directly hit by wrongdoing, are willing to enforce sanctions, since they may obtain future benefits in terms of a reduction in the probability of being the victims of criminal acts.


In the previous section, we examined systems of private ordering which emerge independently of state intervention. As a legal phenomenon, self-regulation is more usually analysed as a deliberate delegation of the state’s law-making powers to an agency, the membership of which wholly or mainly comprises representatives of the firms or individuals whose activities are being regulated.

Public interest arguments for such delegation can be derived from principal–agent theory (Tuohy and Wolfson, 1978). Once the principal (normally, the legislature) has decided that an activity ought to be regulated on grounds of market failure, for example externalities or information asymmetries, the question arises what form of regulation is appropriate. That can be assessed by reference to such variables as the costs of information upon which the rule-making decisions are to be based and those of monitoring compliance and enforcing the rules. The principal may rationally conclude that these costs would be minimised if the tasks of rule-formulation, monitoring, adjudication and
enforcement were to be conferred on a self-regulatory agency (hereafter SRA) (Trebilcock, 1983; Cane, 1987). Since SRAs typically command a greater degree of expertise and technical knowledge of practices and innovatory possibilities within the relevant area than the principal, information costs for the formulation and interpretation of standards are lower.

Delegation to SRAs should thus reduce the principal’s costs of regulation; to what extent will they confer benefits of the kind which regulation is supposed to foster? Take a situation in which the quality of products or services cannot be observed by consumers prior to purchase. Although individual firms will be motivated to provide signals of quality (for example, product warranties), this may be very costly or – where the characteristics of quality are not easily definable – not feasible. It then becomes in the joint interest of the suppliers, as represented by the SRA, to maintain quality by self-regulation (Gehrig and Jost, 1995). And since, in such circumstances, attempts by consumers themselves to measure quality will also be costly and/or futile, such regulation will confer a benefit on them by obviating the need for measurement (Barzel, 1982), as are the costs to the regulatees of dealing with regulators, given that such interaction is likely to be fostered by mutual trust. This aspect is particularly important where, as with advertising, it is difficult to define the desired behaviour with precision and an adversarial relationship between regulator and regulatee is likely to be counterproductive (Baggott and Harrison, 1986). In addition, to the extent that the processes of, and rules issued by, SRAs are less formalised than those of public regulatory regimes, there are likely to be savings in the costs (including those attributable to delay) of amending rules. Finally, once such a regime of self-regulation has been established, individual suppliers have an incentive to supply (at lower cost) lower quality, but since the reputation of other firms will be affected by defaulters, the SRA will be motivated to enforce the standards. On the basis of this analysis, it has been predicted that viable self-regulatory regimes will emerge where monitoring costs for the SRA are low, the number of local markets is small, and customers are relatively mobile as between suppliers (Gehrig and Jost, 1995).

At the same time, there is every reason to expect that SRAs will use their law-making power to benefit their members in ways which are not consistent with the public interest (Horowitz, 1980). As has been formally demonstrated (Shaked and Sutton, 1981a), the self-regulatory rules may create barriers to entry and thus confer significant rents on incumbent practitioners. The latter include non-financial benefits, for example, a quiet life, as well as monetary income (Lees, 1966).

Most obviously, rent may be obtained where the SRA has the power to issue licences and therefore to determine the qualifications of those who engage in the activity (Moore, 1961). But there are also a variety of other ways in which “quality” standards may be used to promote the interests of the regulatees, rather
than those of the public. For example, most professional associations have, at some time or another, prohibited their members from advertising, ostensibly on the ground that “outing” for business is incompatible with the ethical nature of professional practice (OECD, 1985). As we have seen, such bans can eliminate wasteful consumer searches on elusive quality characteristics (Barzel, 1982), but they can also inhibit comparative price shopping, thus generating monopoly rents for practitioners (Trebilcock, 1982).

Secondly, restrictions can be imposed on the legal form used by professional firms (for example, insisting on partnerships and prohibiting corporations) or on the participation of professionals from other disciplines in the firm (OECD, 1985). Both forms of control can add to client costs insofar as they inhibit productive efficiency of the firm (Evans, 1980) and, in some cases, make it necessary for consumers to deal with two or more firms, rather than one (Quinn, 1982). The quality imposed by SRAs may exceed that which presumptively will meet consumers’ preferences and not be justified by externalities; and the excessive cost will be borne by consumers (Treblilcock, 1983). Other welfare losses can arise from the tendency of SRAs to discourage diversity and experimentation (Ostry, 1978; White, 1979).

We are thus left with a trade-off between the inherent pro-industry bias of self-regulation and the improvement in the quality of law-making due to the superior knowledge of the (local) regulators. When is the trade-off resolved in favour of self-regulation and when would it be preferable to leave regulation in the hands of a central authority? Self-regulation yields higher social welfare than government regulation when uncertainty is strong, when the divergence of interests between producers and consumers is small, and when the government attaches a high weight to consumer surplus in the social welfare function (Grajzl and Murrell, 2007). In all these cases, in fact, the trade-off between the pro-industry bias and the increased quality of regulation is dominated by the gains due to more efficient regulation. When there is high uncertainty regarding the characteristics of a given industry, local agents are better equipped to react faster to changes, enacting better rules. Likewise, when producers and consumers have similar preferences, a pro-industry bias cannot be welfare reducing. Finally, when consumers represent a large weight in the government’s objective function, the producers’ lobby is not very strong and it can hardly persuade the government to move away from the social optimum.

These results could explain the tendency of decentralised regulatory regimes to prevail in common-law countries, whereas centralised regulation is widespread in civil-law countries (case law produces more institutional uncertainty and the centralised character of civil law implies a greater efficiency of centralised institutions, such as governmental regulation). Furthermore, different regulatory regimes prevailed in different historical periods. For example, in the United States, during the Progressive Era, centralised regulation was extensively
implemented, whereas self-regulation (although often government supervised) was more common during the New Deal. Scholars agree that the Progressive Era was a period of relative economic stability (low uncertainty), in which interest groups had acquired a strong power and inequality was rising. Conversely, the New Deal followed a period of dramatic economic turmoil, uncertainty was high and the need to protect industries against the risk of bankruptcy led the government to attach a very low relative weight to consumer protection (Eisner, 2000).

In sectors in which corruption and coercion can undermine law enforcement and regulation, laissez-faire may guarantee a better outcome in terms of social welfare (Glaeser and Shleifer, 2003; Nunez, 2010). That is why self-regulation may be preferable to government regulation in securing compliance with safety standards (Baniak and Grajzl, 2009).

If regulation is the object of bargaining between the industry and the governmental regulators, the quality of self-regulation will depend on the relative bargaining power between the regulator and the industry and on the magnitude of the regulatory threat. If the regulator has more bargaining power and there is a high probability that tight government regulation will be imposed on the industry, then the first-best regulatory standard may be implemented through self-regulation. Conversely, if the industry has more bargaining power, then self-regulation results in the implementation of a standard that is lower than the first-best level. In such a case, the voluntarily regulated level might be increased through the use of a subsidy. In the absence of a subsidy, the self-regulated standard will also be lower than the level that might have been imposed legislatively (Segerson and Miceli, 1998, 1999).

5. Preemptive Self-Regulation

So far we have suggested several reasons why self-regulation may be preferable to other regulatory regimes. There are, however, serious implications of the pro-industry bias of self-regulation. Several authors have shown how minimum quality standards can raise welfare when products are vertically differentiated and buyers fully internalise the benefits of quality. By increasing the lowest quality level in the market, the regulator can intensify price competition to the benefit of consumers (Ronen, 1991; Crampes and Hollander, 1995; Scarpa, 1998). However, in an industry in which firms can commit to a quality level before minimum quality standards are implemented, the centralised regulator will be induced to set a more lenient standard and social welfare will fall (Lutz, Lyon and Maxwell, 2000). By acting first and self-regulating quality, the industry plays the role of a Stackelberg leader, influencing the regulator’s choice of the standard and inducing a more lenient regulation (a lower quality standard). This is particularly true in those industries in which self-regulation complements government regulation. Maxwell, Lyon and Hackett (2000) extend
the analysis of pre-emptive self-regulation, imagining a scenario in which, in addition to firms and the public regulator, a third player is active in the regulatory game, namely consumers. They consider a three-stage game with pollution externalities. In the first stage, all firms in an industry jointly choose a level of abatement. In the second stage, consumers decide whether to lobby to increase abatement standards (lobbying is costly). In the third stage, firms compete à la Cournot. In such a setting, by engaging in pre-emptive self-regulation, firms increase consumer surplus, thus reducing consumers’ incentives to lobby for tighter regulation. In fact, lobbying is costly and the higher the level of voluntary abatement, the lower the benefit from lobbying. It is therefore more likely that such benefit becomes smaller than the (fixed) cost of lobbying and consumers’ entry in the “influence game” will not occur. Once again, pre-emptive self-regulation produces weaker standards than is socially optimal. Interestingly, however, given the lobbying costs, self-regulation represents a Pareto improvement over the status quo. A testable implication of this analysis is that an increased threat of consumer lobbying (which occurs when consumers value regulation highly) raises both the industry willingness to implement self-regulation and the level of voluntary abatement. The massive cuts in toxic chemical releases experienced in the United States in the past twenty years may therefore be due to the active role of consumers. The empirical evidence presented by Maxwell et al. (2000), in fact, shows that states with higher initial levels of toxic emissions and better organised environmental groups reduced pollution more rapidly. Given the typical assumption of decreasing marginal benefits from pollution for firms and increasing marginal costs for consumers, in this situation reducing pollution entails relatively low marginal costs for firms and relatively large marginal benefits for consumers. Then the threat of mandatory regulation is strong, while the marginal cost of self-regulation is small; and it is optimal for firms to engage in self-regulation.

The literature on regulatory pre-emption just illustrated may explain the adoption of higher standards than current regulation as an attempt to avoid tighter centralised regulation. Denicolò (2008) presents an interesting alternative hypothesis. There is evidence that, sometimes, self-regulation triggers tighter regulation rather than pre-empting it (see the 1992 California’s Air Resources Board case and DuPont’s lobbying for a tighter regulation of the use of chlorofluorocarbons in the mid-1980s). Then, another possible explanation for the adoption of tighter standards is that “overcompliance” may be used as a signal to the governmental regulator that stricter regulation should be imposed on the whole industry. Why would a firm prefer tighter regulation? The idea is that the firms that overcomply are characterised by relatively low costs of compliance (for example, because they own innovative technological knowledge). If the central regulator is not perfectly informed about the costs of compliance, it
may infer that complying is not too costly and therefore decide to increase the standard. Then, more efficient firms would gain by raising their (less efficient) rivals’ costs.

6. The Enforcement of Self-Regulation

So far, we have neglected a crucial point: the standards implemented through self-regulation need to be enforced. Differently from governmental regulation, whose enforcement costs are borne by taxpayers, in case of voluntary self-regulation, the enforcement costs are typically sustained by the members of the voluntary regulatory agreement. In a self-regulation regime, monitoring and enforcement costs are reduced. Decentralised enforcement usually benefits from a more efficient detection technology and is better suited to levy sanctions on non-compliant parties (Bailey, 1999; Nyborg, 2000; Brouhle et al., 2005; McEvoy and Stranlund, 2010). Thus, a more efficient use of resources should ensue. Finally, decentralised enforcement simply requires the observability of the fraudulent behaviour, given the more informal nature of local sanctioning procedures, whereas centralised enforcement requires that a third party verify the presence of frauds, i.e. it requires both observability and verifiability of deceit (Mayer and Neven, 1991). However, when enforcement costs are borne by the self-regulating agents, it is more difficult for self-regulation to be implemented in the first place. If self-regulation is indeed implemented, however, the number of firms in the industry which agree to participate in the self-regulatory agreement is higher than if enforcement were costless or if the costs were borne by the government (McEvoy and Stranlund, 2010). The intuition for this result is relatively straightforward. Since the enforcement costs are shared among the participants, more firms are needed to make the self-regulatory agreement profitable. Thus, if an agreement is formed at all, it will involve a higher number of firms.

Participation in self-regulating groups and enforcement raise two crucial issues in self-regulation: free-riding and the credibility and severity of internal punishment. If an industry can avoid centralised regulation by forming a voluntary agreement with less than full participation, firms that do not join can reap the benefits from avoiding the superimposed regulation without having to bear the costs of self-regulation (Dawson and Segerson, 2008). Although this is a problem concerning mainly the types of self-regulation that require an investment by the participants (such as, for instance, pollution abatement schemes), it nevertheless raises very important concerns about the feasibility and stability of the self-regulating agreements. Such concerns seem to be supported by empirical evidence. For instance, the European Environmental Agency (EEA) notes that small and medium enterprises typically display a high degree of free-riding (EEA, 1997).
As for punishments, Mayer and Neven (1991) consider the possibility of errors in sanctioning and argue that the severity of punishments should be mitigated to take into account the possibility of punishing innocent firms. Moreover, when a self-regulating group or industry sanctions one of its members, it publicly reveals that the latter has breached the rules the group had agreed upon. This may lead consumers to update their beliefs on the behaviour of all firms, reducing the perceived quality (this is especially true in the case of experience and credence goods). Then, a self-regulated group may have weak incentives to punish, for fear of ruining its reputation and damaging its honest members. Sanctioning “might be a negative signal about the average quality of remaining members” and “a sign that the fraudulent member thought that vigilance was low enough for there to be a reasonable chance of getting away with it” (Vickers, 1991).

7. Rent-Seeking Theories of Self-Regulation
In the light of public choice theory, rent-seeking explanations of regulation are, of course, commonplace (Tollison, 1982). If rule-making remains with the legislature or an independent agency, interest groups representing the regulatees have the task of exerting influence on those institutions and diverting them away from public interest goals or other, competing private interest claims. Of course, delegation of the regulatory powers to SRAs relieves the groups of this task and the relative absence of accountability and external constraints maximises the possibilities of rent-seeking—“with self-regulation, regulatory capture is there from the outset” (Kay, 1988). Governments are motivated to maintain or extend the use of self-regulation because, while they may derive political benefits from measures which appear to benefit consumers and others, the costs are not revealed in any public accounts (Trebilcock, 1983).

And it is difficult for the cost-bearers both to determine the amount of wealth transfers and to coordinate their activities in opposing them (Van den Bergh and Faure, 1991). Although, as we shall see in the next section, there is considerable empirical evidence to support this theory of self-regulation, it has not gone unchallenged. Dingwall and Fenn argue that it cannot explain the persistence and stability of entry restriction; other forces must be at work to prevent pressure from potential entrants building up to an intolerable level (Dingwall and Fenn, 1987). Such forces may lead to the emergence of illegal (or “informal”) markets (De Soto, 1989), or of reasonably close, but unregulated, substitutes (Fisher, 1997). Indeed, it may be an inherent feature of regulation that it cannot control every margin of adjustable behaviour, and thus rents are dissipated as firms seek to trade on these uncontrollable margins (Cheung, 1974).

Weingast also finds it hard to reconcile the theory with the fact that many of the self-imposed restrictions can dissipate rents or seem designed to increase a perception of quality maintenance at the expense of greater rents (Weingast, 1980). Drawing on Arrow’s public interest analysis (Arrow, 1963), he sees self-
Self-regulation as performing a symbolic informational function: as a consequence of the uncertainties as to both quality in the unregulated market and the effects of regulation, there is a tendency for SRAs to adopt policies which improve observable features of the activity and give the appearance of service uniformity.

8. Sector-Specific Studies

Some studies of self-regulatory systems support the notion of spontaneous, private ordering described above. For example, there are incentives for banks voluntarily to become members of private protective and certifying agencies (Gorton and Mullineaux, 1987; Gehrig and Jost, 1995), and for voluntary “best practice” auditing and other standards to be diffused among different SRAs (Belcher, 1996). The global financial crisis of 2008 has seriously questioned the effectiveness of self-regulation and auditing in financial markets and in the banking sector (Rajan, 2005; Canova, 2009; Emeseh et al., 2009; Zamagni, 2009). The debate on the merits of adopting a regime of self-regulation in financial markets nevertheless remains vibrant. De Marzo et al. (2005) have shown that self-regulation generally results in a lower degree of market transparency, because agents have the incentive to misrepresent cash flows to customers. Government supervision is then required to induce stricter enforcement and greater transparency. Stefanadis (2003), on the other hand, argues that self-regulation yields higher social welfare than government regulation in markets characterised by high rates of innovation (as financial markets are). This is because self-regulation eliminates certification-related delays in the adoption of financial innovations. It is important to notice, however, that pure self-regulation might not be enough to guarantee market discipline even in the presence of innovation. An appropriate form of “co”-regulation is required, where the threat of government intervention compels agents to pursue social optimal goals to avoid external regulations. Many scholars agree that the financial crisis in 2008 has been due to either ineffective or non-existent government regulation, whereas financial innovation has been devoted to sustain returns on riskier and riskier assets (Greenlaw et al., 2008; Reinhart and Rogoff, 2009; Duffie, 2010).

In the advertising industry, self-regulation has emerged as the suppliers have perceived the benefit to be obtained from acquiring public creditability for their products and from creating an image of professional responsibility (Battcock and Harrison, 1986, Schwartz et al., 2010). But these researchers also highlight the problem of enforcement: SRAs begin to adopt an aggressive stance only where there was perceived to be a threat of intervention by public agencies. The same phenomenon has been observed with the self-regulation of commodity exchanges (Pirrong, 1995; see also Page, 1987; Fishman, 1993; Black, 1997). Investigations of occupational health and safety systems, as they have increasingly shifted towards decentralised standard-setting by local arrangements between employers and employees, suggest this has been effective.
Production of legal rules

when the systems can be related to nationally established standards and are supported by knowledge that the arrangements will be enforced (Dawson et al., 1988). But there has been a decline in protection against risks created by small or non-unionised firms (Baldwin, 1987; Smith and Tombs, 1995).

An important field which has attracted a lot of attention recently is consumer protection. Several modes of consumer regulation are currently adopted in the industrialised world: centralised agencies, third-party institutions (e.g. ombudsmen) and regimes of self-regulation, the latter often aided by consumer associations. Self-regulation is efficient when there is a culture of proactive complaints by consumer associations and wrongdoing is easily detectable (Faure, Ogus and Philipsen, 2009; Hadfield, 2001).

Also the regulation of the cyberspace is presenting new challenges (Price and Verhulst, 2005; Tambini et al., 2008). During the 1990s, self-regulation was strongly advocated. Recent years have, however, seen a shift towards regimes of “co”-regulation of the internet (see, for instance, the 2007 European Commission’s Audio Visual Media Services Directive), in which self-regulatory structures are required to coordinate with centralised regulatory institutions (especially in matters regarding public order, like crimes related to pornography and gambling).

Cybersecurity is another important field in which the debate of government versus private (self-) regulation has been very lively. As in the case of internet regulation, cybersecurity is a field in which the market may be unable to produce a solution. There is in fact a relevant free-riding problem, since computer users bear the full cost of protection, while the benefits are shared by the entire network. This might therefore call for centralised regulation. However, computer networks are globalised, extending far beyond the jurisdiction not only of all nations but also of all federations of states (Grady and Parisi, 2006). A complex system, in which some issues are left to self-regulation, whereas most critical ones are regulated through international cooperation, may therefore be the best way to deal with cybersecurity (Trachtman, 2006).

Beginning with the pioneering work of Friedman and Kuznets (1945), published at the end of the Second World War, most attention has been given to regimes governing the professions (for a valuable survey of studies relating to the medical professions, see Gravelle, 1985). Typically, the regimes involve SRAs having the power to issue licences and therefore the ability to restrict entry (see Kessel, 1970, for a study on how control by the SRA was used for the benefit of members of the profession). The prediction that this will enable incumbent practitioners to earn rents is difficult to substantiate because it is necessary to disentangle supra-competitive profits from higher earnings which represent legitimate compensation for higher educational costs and greater responsibilities. Nevertheless, when such variables are controlled for, researchers have found strong evidence of rents being earned by eyeglass suppliers (Benham
Self-regulation and Benham, 1975), dry cleaners (Plott, 1965), lawyers (Holen, 1965; Lees, 1966; Domberger and Sherr, 1989; Curran, 1993) and dentists (Holen, 1965; Shepard, 1978; Wilson, 1987). Studies on other medical professions (Holen, 1965; White, 1979; Wilson, 1987; Curran, 1993) and architects (Button and Fleming, 1992) are less conclusive.

In a general study, Maurizi found that there was a significant correlation between licensing regimes and monetary returns for about half of the systems examined (Maurizi, 1974). Exacerbation of shortages in the supply of practitioners (Hogan, 1979), maldistribution of such supply (Holen, 1965; Boulier, 1980; Pashigian, 1980) and poorer quality of service (Caroll and Gaston, 1979) are other welfare effects found to have resulted from licensing regimes.

Ongoing professional standards, established by SRAs, have also enabled them to protect anti-competitive practices: for example, fee regulation and restrictions on advertising which limit price competition (Benham, 1972; Office of Fair Trading, 1982; Domberger and Sherr, 1989; Van den Bergh and Faure, 1991); and “professional ethics” which serve the well-being of practitioners rather than their clients and mask prohibitions on cost-saving innovation (Gravelle, 1985; Trautwein and Rönnau, 1993).

Kleiner (2006) presents a comprehensive survey on the effect of professional licensing. He finds little evidence of a positive relation between licensing and the quality of the services provided. He also analyses the impact of licensing on earnings, finding that professionals enjoy much higher earning premia in the US than in Europe. A possible explanation may be the relative wage rigidity characterising Europe, which may cause licensing to produce effects more through reduced employment than through prices, whereas the opposite seems to hold for the US. Overall, Kleiner concludes that the costs of licensing greatly outweigh the benefits. Therefore a different system may be preferable, i.e. certification, which provides many of the advantages of licensing but leads to more competition and lower entry barriers.

9. Competitive Self-Regulation

The above discussion suggests that, on certain key assumptions, systems of spontaneous private legal ordering can generate efficient outcomes, but that state-delegated systems of self-regulation can lead to adverse welfare effects.

The crucial factor which distinguishes the two systems is that the act of state delegation normally involves conferring on the SRA a monopoly power to legally constrain supply in the relevant market. We have seen (Baggott and Harrison, 1986; Pirrong, 1995) that the threat of state intervention may, to some extent, mitigate the harmful effects of monopolisation. A useful analogy may here be drawn with the theory of contestable markets which indicates that, under certain conditions, efficient pricing and production can be forced upon a monopolistic supplier by the threat of competition, just as much as by actual
production (Baumol, Panzar and Willig, 1982). But the necessary conditions – notably the ability of the entrant costlessly to leave the market – are rarely met in practice (Waterson, 1988).

Similarly, on cost grounds, SRAs may not regard the threat of state intervention as credible.

An alternative solution to the problem presents itself: if the principal objection to SRAs is that they are able to exploit their monopolistic control of supply so as to enable practitioners to earn rents, then why not force SRAs to compete with one another, so that the rents will be eliminated (Kay and Vickers, 1990; Ogus, 1995)? Such competition would obviously prevent SRAs creating barriers to entry. But it should also constrain SRAs to formulate standards which meet consumer preferences at lowest cost since, assuming consumers have adequate information to make appropriate comparisons, they will choose the combination of price and self-regulatory standards which most closely corresponds to those preferences.

Competition of this kind is inherent in systems of private ordering: suppliers compete to attract consumers by the quality (as well as the price) of their products and services. Quality is, to some extent at least, a consequence of standards and other forms of control imposed internally by the management of a firm. The standards may reflect public regulatory requirements, but more often they are voluntary, representing the firm’s response to assumed consumer demand and, in some cases, incorporating industry-wide practices. To signal to consumers the relationship between standards and quality, some form of voluntary accreditation or certification can be used (Bardach and Kagan, 1982).

Suppliers who aim at different quality standards, and have difficulty in communicating that fact to consumers, will have an incentive to establish a rival certification system. Competing self-regulatory regimes may thus emerge. Thus envisaged, competitive self-regulation is, in essence, no different from competition between national public regulatory regimes (Bratton et al., 1997). If there is mutual recognition of national standards and freedom of trade, consumers can choose between the different quality standards imposed by the national systems in accordance with their own preferences. Provided that they are informed as to the relevant national compliance certificate, competition between national regulatory regimes should induce standard-setters to meet those preferences (Kay and Vickers, 1990).

The policy implication of this analysis is that where the public interest arguments for the state delegating its regulatory powers are strong (see above), it should not grant monopoly power but rather enable two or more SRAs within a given supplier group to formulate alternative regimes (Ogus, 1995; for the effects of competition between professionals and para-professionals, see Shaked and Sutton, 1981b). Although there is a risk of cartelisation, most industries are sufficiently heterogeneous for this purpose. An alternative is to retain the
monopoly but force different SRAs to compete ex ante to acquire the right to control supply by self-regulation. Competing applicants would be required to include their self-regulatory rules as part of the bid; and, as with other public franchises (Demsetz, 1968), the competition should force applicants to offer regimes consistent with the public interest.

There are, nevertheless, potential problems with these solutions. Consumers – more precisely marginal consumers (Schwartz and Wilde, 1979) – must be able to attribute general quality characteristics to certificates generated by the competing self-regulatory regimes; otherwise there will be a “race to the bottom” (Akerlof, 1970). Secondly, there must be no significant externalities arising from their purchasing behaviour. The importance of information asymmetries and externalities and, in relation to the franchising solution, the need to scrutinize competing bids suggest that in many areas some residual form of state intervention will be optimal. It remains to consider this issue more generally.

10. Mixed Systems

As was indicated in the discussion of the nature of self-regulation, there is a wide range of possible institutional arrangements between public regulation on the one hand and pure private ordering on the other. In an effort to realise many of the benefits of self-regulation, but controlling the costs which result from SRA rent-seeking, some jurisdictions have adopted what has been referred to as “coregulation” (Grabosky and Braithwaite, 1986): SRAs regulate with some oversight or ratification by government, or officials representing the public interest (see for example Page, 1987). The main problem is that of informational asymmetry between the public agency and the SRA. The latter can withhold vital information unless there is confidence that it will be used to reach regulatory solutions which favour its members (Quirk, 1981). Typically, also, the SRA retains monopolistic control of enforcement.

In an important contribution to the literature, Ayres and Braithwaite argue, instead, for “enforced self-regulation” (Ayres and Braithwaite, 1992; see also Braithwaite, 1982). Under this model, a public agency negotiates with individual firms regulations that are particularised to each firm, with the threat of an imposition of less tailored standards if it fails to cooperate. While the firm may thus formulate the rules, they are enforced by the public agency. The advantages are clear: as with other privately ordered systems, the rules are tailored to match the firm’s circumstances and are less costly to adapt; there are incentives to identify least-cost solutions, which should encourage regulatory innovation; and firms would be more committed to the rules than if imposed externally. Moreover, the very fact of individualisation avoids the monopoly problem. On the other hand, the administrative costs would be high. This suggests that, for such a regime to be cost-effective, the firm must be large and the activity to be
regulated must be one in which efficiency requires significantly differentiated standards (Latin, 1985).

Finally, an important case of “mixed regulation” is “co”-regulation, described in Section 2 and investigated thoroughly by, among others, Bartle and Vass (2007).

11. Morally Motivated Self-Regulation and Corporate Social Responsibility

Self-regulation can be motivated by self-interest. In the literature surveyed above, firms resort to self-regulation to increase profits, be that through pre-emption of tougher regulation or through increasing rivals’ costs.

Self-regulation can be motivated also by altruistic moral concerns. Consider, for example, a setting in which economic agents (private individuals and firms) face opportunities to free-ride on the self-regulation of other agents they interact with. In such a setting, self-regulation should be defined in a broad sense as the voluntary (private) provision of a public good. According to whether agents are private individuals or firms, the nature of the public good may change and thus the type of self-regulation. For instance, individuals may engage in the abatement of environmental externalities, they may contribute to community projects or they may purchase products only if they are produced in factories that do not exploit child labour. Similarly, firms may self-regulate by abating production externalities, treating workers well and employing sustainable inputs in the production process (i.e., roughly speaking, by following principles of Corporate Social Responsibility). Baron (2010) shows that the stronger the altruistic component in the individual utility function, the higher the incentives to adopt self-regulation. However, the extent of self-regulation is influenced by various factors, among which are the sensitivity of altruism to “closeness” and the incentives to free-ride on more altruistic trading partners. Some people, in fact, tend to be very altruistic within their kin group, but do not cooperate with agents outside their group. This is a first type of free-riding and can occur also among people with preferences characterised by the same degree of altruism. When preferences are not homogeneous, so that there is moral heterogeneity in the society, a second type of altruism can arise, in which those with weaker preferences for altruism free-ride on the cooperative behaviour of those with stronger preferences for altruism.

When agents choose to self-regulate, besides performing individual altruistic actions, they can also form voluntary organisations. Such organisations reinforce the scope of self-regulation, enhancing public good provision. Baron (2010) distinguishes between two types of voluntary organisations: enforcing organisations and informational organisations. Enforcing organisations have the capability to adopt strategies that raise the costs of non-contributing. Such costs could consist either in a loss of reputation due to public exposure in case
of non-compliance, in the application of social sanctions, or in the exertion of social pressure. Examples of such organisations could be NGOs monitoring working conditions in factories or reporting cases of environmental abuse. Informational organisations lack enforcement capabilities; they simply provide information, allowing agents to interact with others with similar preferences. Such organisations provide social labels (labelling organisations) or monitor the conduct of a trading partner (certification organisations). Enforcing organisations enhance cooperation in the presence of the first type of free-riding, since they extend altruistic behaviour towards individuals not immediately close to the kin group. Conversely, labelling and certification organisations are most effective in tackling the second type of free-riding. For instance, social labelling allows agents to interact with others with similar preferences, reducing the risk of meeting less altruistic individuals and to be subject to free-riding. By joining a social label organisation that is especially tailored to the needs of a given group of individuals, agents can credibly reveal their type to others. Consider, for example, a “green club”, where consumers are sure they can buy from retailers that meet green standards. This enhances cooperation every time altruism is reciprocal, i.e. every time the propensity to cooperation is positively related to the expectation of reciprocation by the counterpart. A similar effect of risk reduction is achieved by certification organisations that expose the past behaviour of trading partners.

It is immediate to extend these results to Corporate Social Responsibility (CSR) practices. CSR firms are in fact instruments through which both entrepreneurs and private citizens fulfil their altruistic preferences. The creation of a CSR firm expands the opportunities for cooperation for both social entrepreneurs and consumers/shareholders interested in social giving. To see how this occurs, consider an altruistic investor, who has the opportunity to buy shares in the capital market and to use the financial returns on those shares to (privately) provide public goods. A CSR firm can be defined as a firm involved in the provision of public goods. Individual and corporate altruism are substitutes, hence CSR practices crowd out private altruism. Generally speaking, however, they are imperfect substitutes. Then there will be individuals who draw a greater utility from corporate than from their private altruism. Such individuals will buy shares of CSR firms, reducing their private contributions to public goods accordingly. Conversely, those who prefer private giving hold no shares in CSR firms. CSR firms thus represent institutions through which citizens (in the role of investors) expand their self-regulation (Baron, 2007, 2008). Needless to say, if corporate altruism were a perfect substitute for private altruism, CSR would have no reason to exist.

This theory can also explain why perfectly rational entrepreneurs sacrifice profits in the social interest (Friedman, 1970; Baron, 2001; Reinhardt, Stavins and Vietor, 2008). If citizens derive social satisfaction from corporate altruism,
they will invest in CSR firms even if such firms do not maximise profits. Then, in a society characterised by heterogeneous individuals, there will be firms that maximise profits and CSR firms, which redistribute profits to social causes.

If CSR is a self-regulation device in the sense of Baron (2010), then not only does it help private citizens to expand their set of cooperative actions, but CSR firms themselves may act opportunistically, facing incentives to free-ride. Such incentives will be reduced by enforcing institutions and by the informative action of labelling and certification organisations (the activity of NGOs is very important in this respect; see Lyon and Maxwell, 2008, for an illustration in the field of environmental CSR). Interestingly, CSR firms are subject to another important disciplining force: competition. Empirical evidence points to the existence of a negative relation between measures of market concentration and the extent of CSR activities (Fernández-Kranz and Santalo, 2010). This is taken as evidence that firms engaging in CSR do not suffer a reduction in profits and that CSR is “a way to either better differentiate, gain access to new markets, or achieve a better fit between the firm’s products and services and consumer preferences in some unique market niches” (Fernández-Kranz and Santalo, 2010, p. 454). Then, most forms of CSR would not be altruistic (where altruistic CSR sacrifices profits for the social interest) but would rather be “strategic” (Baron, 2001): companies that “do well by doing good”. According to such a view, CSR firms are for-profit institutions that specialise in the provisions of goods and services that allow consumers to expand the set of their altruistic actions.

Bibliography
Benson, Bruce L. (1990), The Enterprise of Law: Justice without the State, San Francisco: Pacific Research Institute for Public Policy.
Buskens, Vincent (2002), Social Networks and Trust, Boston, MA: Kluwer Academic Publisher.

Self-regulation 247

Gerrit De Geest - 10.4337/9781782540519.00021
Downloaded from Elgar Online at 11/26/2018 06:10:00PM
via free access
Production of legal rules


250 Production of legal rules


Tambini, Damien, Leonardi, Danilo and Marsden, Christopher (2005), *Codifying Cyberspace: Communications Self-Regulation in the Age of Internet Convergence*, Abingdon, UK: Routledge.


**Other References**


252 Production of legal rules


Office of Fair Trading (1982), *Opticians and Competition*, HMSO.


