

Elected versus Appointed Regulators

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A key issue in political economy concerns the accountability structures put in place to select public officials. While the principle that legislators are to be elected is now a defining feature of modern democracies, there are some offices where a plurality of selection methods survive. A key example is the case of regulators. Typically, heads of regulatory agencies are appointed by politicians, creating an insulating layer between citizens and regulators. However, a number of U.S. states have injected a degree of populism into the regulatory process by requiring that the heads of their independent regulatory commissions be directly elected. Insurance regulation has a similar structure with several states also electing their insurance commissioners.

For students of political economy this raises three key questions. First, can we develop a satisfactory theoretical understanding of the likely differences between regimes of election and appointment? Second, does the data yield robust lessons? Third, does the data square with the theory? The U.S. states provide a natural panel data laboratory for this investigation. We observe both time series and cross-sectional variation in the decision to elect or appoint.

On any first encounter with the idea of popular election of regulators, one is drawn to the proposition that consumer interests might be served more intently by elected regulators since they are more likely to have their eye on the ballot box. Indeed a number of contributions to the literature seem to begin with the observation that this is self-evident. However compelling this might seem, further thought reveals this claim to be inconsistent with the view that representative democracy yields median policy outcomes. Since those who appoint the regulators are themselves elected, then they would surely have as much interest in promoting consumer interests as directly elected regulators? Hence, we might expect either regimes with electing or appointed regulators to track the median voter's wishes on regulatory policy and authors including Baron [1995] and Laffont [1996] have modeled things this way. Any

empirical differences could only be traced to differences in turnout and the composition of the electorate in different kinds of election.

A belief that election of regulators matters does require us to work with a theoretical structure outside a naive form of the Downsian model of representative democracy. Vague gestures towards support maximization a la Stigler [1971] and Peltzman [1976] are not particularly helpful either as these models rarely model the details of the institutional structure. Nonetheless, their proponents have ventured the important insight that the interplay of democracy and concentrated interests (organized or otherwise) may be important to understanding the difference between election and appointment of regulators. To use Stigler's language, the degree of *regulatory capture* by stakeholder interests may vary across regimes that elect and appoint regulators. However, sharpening insights about this does require a satisfactory theoretical account which models representative democracy and the actions of interest groups. Theoretical approaches in political economy that combine these features are still a rarity.

Besley and Coate [2000] provides the first fully developed treatment of the claim that direct election of regulators, rather than appointment by elected politicians, should lead to more consumer-oriented regulatory policies. In doing so, it makes explicit the importance of the fact that regulation is bundled with other issues when regulators are appointed. Because voters have only one vote to cast and regulatory issues are not salient for most voters, bundling provides parties with electoral incentives to respond to stakeholders in the regulated industry. Navarro [1982 pages 126-7] has suggested an argument along these lines. The result is a sort of regulatory capture that emerges endogenously through the electoral process because of diffuse costs and concentrated benefits. If regulators are elected, their stance on regulation is the only salient issue so that the electoral incentive is to run a pro-consumer candidate. The same logic holds when producer interests are organized as an interest group capable of making campaign contributions to influence policy outcomes.

Most empirical work on the difference between electing and appointing states has concentrated on regulation of public utilities. There have been some changes in regimes over time. In 1960, fourteen states elected their utility commissioners, falling

to eleven by 1997. This general trend masks the fact that six states switched their method of selecting regulators.

The large empirical literature on the effects of regulation begins with Stigler and Friedland [1962]'s seminal study of electricity prices, comparing states which regulated prices with those that did not. (The literature as whole is expertly reviewed in Joskow and Rose [1989].) The cross-state variation between regulatory regimes in the United States has understandably been a rich testing ground for the economic effects of regulation. That institutional variation afforded by rules for appointing public utility commissioners in the U.S. provides ample scope for empirical testing. The earliest studies include Berry [1979], Boyes and McDowell [1989], Costello [1984], Crain and McCormick [1984], Harris and Navarro [1983], Navarro [1982], and Primeaux and Mann [1986], each of which looks at the evidence from a different perspective. Some of these contributions looked at rate setting, while others have looked at broader indicators of how favorable is the regulatory climate within a state. Costello [1984]'s review of the early evidence concludes that "In summary, it probably makes little difference to the average ratepayer whether a PUC is elected or appointed." (page 104). Looking at more recently available evidence overturns this conclusion -- there is now good evidence that elected regulators are more pro-consumer in their outlook.

Formby, Mishra and Thistle [1995] find this in their examination of electric utility bond ratings. Using data from 1979-1983 on a selection of investor-owned utilities, they find that election of public utility commissioners has a negative effect on bond ratings, consistent with a squeeze on margins due to more pro-consumer choices. Fields, Klein and Sfiridis [1997] find evidence that elected commissioners from the insurance industry are more pro-consumer. They report that the market value of life insurance companies doing business in California declined sharply following the passage of Proposition 103, which changed the method of selection of the insurance commissioner from appointment to election. Using data from 1985, Smart [1994] reports that telephone rates are lower in states that elect their public utility commissioners.

Besley and Coate [2000] look at differences in long-run (conditional) mean electricity prices for three types of tariff (residential, commercial and industrial) for a panel of 40 states that did not change their regulatory regime between 1960 and 1997. They find that residential prices are significantly lower in states that elect their regulators -- their point estimates amount to around \$60 per household per year at 1992 prices. The conditioning variables in the study are year fixed effects, a state specific cost index, and other demographic and economic variables. They also show that states with elected regulators are less likely to pass through cost changes into prices. Both of these are consistent with the idea that elected regulators are more pro-consumer in their outlook.

So why the difference between the older and newer work? The three studies conducted in the 1990s were looking either at different kinds of regulation (Fields, Klein and Sfiridis [1997] and Smart [1994]) or at very different outcome measure (Formby, Mishra and Thistle [1995]). Besley and Coate [2000] is more similar. However, in contrast to the previous literature, it exploits panel data and looks for long-run price differences rather than identification within a given year. This helps to alleviate the major concern within a cross-section that the decision to elect or appoint regulators is simply correlated with important unobservable differences between states. Their tests on pass through also exploit interactions between the regulatory regime and a time-varying (production costs).

A key question is who pays for lower prices in states that elect their regulators. Lower prices are likely to raise total surplus but, without lump-sum transfers there are gainers and losers. (Moreover, there are also long-run consequences to be considered to which we return below.)

In distributional terms, one (benign) possibility is that lower prices simply shift rents from shareholders to consumers. In this case, even if total surplus rises, the outcome from a welfare analysis that was sensitive to distribution would depend upon the relative weights that are placed on the payoffs of these two groups. Assuming that policy changes in the regulatory dimension are all that count, electing utility commissioners will be welfare enhancing if this rent transfer is desirable.

However, it is likely that lower prices have effects on other decisions, particularly the decision to invest. In the early years of U.S. utility regulation, the negative effects of regulator populism on incentives to invest was an abiding concern (see Troesken [1997] for an important and persuasive discussion of this). Indeed, in part, this was behind the reason why the utilities themselves lobbied in favor of state level utility regulations to replace regulation at the local level. Once a utility had sunk its capital, it was reliant on the regulator to allow prices commensurate with earning an acceptable rate of return. Locally accountable regulators were more likely to be tempted to lower prices in order to gain popularity. In his study of gas companies, Troesken [1997] observes that “state utility commissions helped local governments credibly commit to reasonable regulatory policies. This made it easier for cities and towns to attract private capital. State regulation helped local governments commit because gas companies believed that state regulators were more sympathetic to producers than were local regulators (page 9).” This brings into sharp relief the possible dilemma of populist regulation in a dynamic framework. These hold-up problem type of issues are recognized in the extensive theoretical literature on regulation -- see, for example, the discussion in Laffont and Tirole [1993].

One important consequence of investment decisions in the United States is service reliability. This remains an important concern of regulators in the United States, the salience of which has been enhanced by the recent experience in California. Moreover, there is a feeling that there are important interactions between price regulation and service quality [see, for example Phillips [1988] page 507]. This type of argument suggests that we might expect to see less investment in the electricity network in states that elect their regulators given our finding that prices are lower in these states. In suggestive evidence that investment may be lower, Besley and Coate [2000] use data on the number of power interruptions experienced in the States between 1984 and 1997 to show that states with elected regulators have more power interruptions.

In studies of this kind, it is important (and sometimes difficult) to be sure that being elected is not just proxying for other dimensions of regulatory rules. It is interesting to note that Navarro [1982] finds that states that elect their regulators show a more unfavorable regulatory climate according to his rankings of states gleaned from a

number of commercial organizations. This is consistent with the finding that prices are lower in electing states although it is also possible that states with elected commissioners also have stronger regulatory institutions. However, looking at the measures from Norton [1985], the only states that elected commissioners in his sample were classified as weakly regulated (Norton [1985] Table 1) (See also Costello [1984] Table 7.) Gormley [1981] observes that consumer movements are much more likely to be active in states where the public utility commissioner is appointed. This underlines the possibility that, over time, there can be important private responses to regulatory regimes that may affect the climate and thence become possible sources of omitted variables in empirical studies.

A key issue, which is still poorly understood, concerns the possibility that the choice of regulatory regime is endogenous. This is a tall order for empirical analysis given the relative rarity of switches in regimes. The insights from the theory and evidence suggest that this should itself be driven by the forces that shape the politics of consumer and stakeholder interests. In general, the choice of institutions remains an important, but elusive, area in empirical political economy. However, it is clearly an important agenda for the future.

The study of elected versus appointed regulators leaves little doubt that this kind of accountability structure matters in theory and practice. Moreover, the available evidence should be useful in informing debates about the design of regulatory institutions. The U.S. experiment with a more populist process does appear to yield benefits to consumers. The costs are harder to quantify. However, it is clear that election of regulators is something that merits serious consideration.

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