

The Emergence of Regulation: Market Failure, Subversion of Justice and Inadequacy of Private Law

MUHAMMED KOROTANA

Abstract

Often the justifications for the emergence of public regulation have been explained as instances of ‘market failure’. In such instances, it is always argued that somehow an unregulated market has failed to produce social outcomes in accordance with the public interest. Market failure theory is a classic economists’ view regarding the emergence and justification of regulation. Nevertheless, market failures are ubiquitous and so cannot be put forward as a theory to explain the emergence of regulation. However, one might like to think from a different perspective – from a legal point of view – that regulation actually emerges because of the subversion of justice, inefficiency or inadequacy of the common law. It is the failure of contract and tort law as a mechanism to secure property rights that has prompted the emergence of regulation. However, there is another view that regulation also emerges on the basis of ideas of fairness and rights.

A. Introduction

There is always a rational explanation or justification for the emergence of a new regulation, except in very exceptional circumstances where a government wants to regulate for some selfish or irrational motive, such as a means to win the next election. Most of the justifications for regulation have been explained as instances of ‘market failure’. In such instances, it is always argued that somehow an unregulated – in other words uncontrolled – market has failed to produce social outcomes in accordance with the public interest.¹ Market failure theory is a classic economists’ view regarding the emergence and justification of regulation. Nevertheless, market failures are ubiquitous and so cannot be put forward as a theory to explain the emergence of regulation. However, one might like to think from a different perspective – from a legal point of view – that regulation actually emerges because of the subversion of justice, caused by inefficiency or inadequacy of the common law. The common

¹ J Francis, *The Politics of Regulation*, Ch. 1 (Oxford, 1993). For public interest justifications see generally: A Ogus (n 10) Ch. 3; S Breyer,(n 11) Ch. 1; T Prosser, *Nationalised Industries and Public Control: Legal, Constitutional and Political Issues* (Oxford, 1986); C Hood, *Explaining Economic Policy Reversal* (Buckingham, 1995); C Sunstein, *After the Rights Revolution: Reconceiving the Regulatory State* (Cambridge, MA, 1993); E Gellhorn and RJ Pierce, *Regulated Industries*, Ch. 2 (St Paul, MN, 1982); J Kay and J Vickers, *Regulatory Reform: An Appraisal*, in G Majone (ed), (n 9); BM Mitnick, (n 9).

law has proved to be vulnerable to the realities of human nature in the market place; it is the failure of contract and tort law as a mechanism to secure property rights that has prompted the emergence of regulation. There is another view that regulation also emerges on the basis of ideas of fairness and rights. Furthermore, for some, the emergence of regulation is always for political reasons. It can therefore be seen that there are a number of rationales for the emergence of regulation. This study begins with the discussion of the notion of regulation and progresses along the discussions of the concept of ‘market failure’, theory of subversion of justice and ideas of rights and justice, and inadequacy of private law. In this vein as it discusses the justification for regulation in the positive sense, the main focus of the study is positive as to why regulation emerges; it thereby hypothesises that regulation emerges due to the subversion of justice.

B. Notion of Regulation

One might say that regulation has existed as long as governments, as governments have often interfered in private matters.² To make this discussion of regulation manageable and meaningful, it focuses on the term in its modern sense. The term ‘regulation’, as such, is not definable in a generic sense as a single concept. However, it becomes considerably easier to define when seen through the ‘taxonomy of regulation’. Regulation may be broadly classified as public or private (self-regulation)³ regulation, or legislative or non-legislative regulation. The former is the focus of this study. In a general discourse, *prima facie* regulation means public regulation; it is a term of art⁴ that has a widely accepted meaning under state law⁵, excluding common law. It would be futile and irrational to offer a single authoritative definition of the concept of regulation that holds across the public/private regulatory divide⁶ because the origins and normative foundations of the two are different. Public regulation is a binding legal norm created by state powers for the purpose of shaping the behaviour of persons both natural and legal.⁷ The state has a monopoly over the coercive power

² Expropriation and distribution of wealth by kings or dictators by fiat is not regarded as regulation and therefore does not form the part of the discussion.

³ See N Gunningham and P Grabosky, *Smart Regulation* (Oxford, 1997). The authors make a point for the role of regulation by corporations, professional and trade bodies, voluntary organisations and self-regulators along with state regulation, and indicate where state and private regulation can work more effectively.

⁴ *Cf. Molzof v. United States*, 502 U.S. 301, 112 S.Ct. 711, 116 L. Ed. 2d 731(1992).

⁵ R Baldwin, M Cave and M Lodge, *Understanding Regulation: Theory, Strategy and Practice*, 2 (Oxford, 2012); Baldwin, Scott and Hood, *Regulation*, Ch. 1.

⁶ J Jordana and D Levi-Faur, *The Politics of Regulation in the Age of Governance*, in *The Politics of Regulation: Institutions and Regulatory Reforms for the Age of Governance* (2005); WJ Novak, *Common Regulation: Legal Origins of State Power in America* 45 Hastings L.J. 1061, 1071 (1994).

⁷ See DP Baron, *Design of Regulatory Mechanisms and Institutions*, in R Schmalensee and RD Willing, eds., *Handbook of Industrial Organisation*, Vol.2, 1349 (1989) (“Regulation involves government intervention in markets in response to some combination of normative objectives”).

of law. It is created by a legislature or administrative or executive authority that has the legal power to create a binding legal norm.⁸ Whereas private regulation is unable to make itself into a legal norm, it does not have state power behind it. Private regulation is created and enforced as a contractual arrangement, not by state direction, restriction, command and control or state influence. However, one philosophical argument that may hold for any type of regulation is that the idea of regulation is to guide all concerned participants away from an undesirable action and towards a desired one.⁹

The notion of public regulation has been defined in a number of ways.¹⁰ However, there seems to be a consensus among various authors that at the basic level it represents state intervention in private law. Ogus sees regulation as the ‘*necessary exercise of collective power through government*’.¹¹ This connotes elastic or coefficient collective power, incorporating command and control techniques as well as persuasive influence.¹² Selznick views the concept of regulation as sustained and focussed control exercised by a public agency over activities that are valued by a community.¹³ Baldwin and Cave see regulation as ‘*deliberate state influence*’ whereby it covers all state actions designed to influence industrial or social behaviour.¹⁴ This terminology explains the concept in its full scope. *Deliberate state influence* is the same as the necessary exercise of collective power through government. Selznick limits regulation to secondary legislation, whereas Ogus and Baldwin and Cave include primary legislation within the definition of regulation. These views convey the central meaning of regulation, whether be restrictive or facilitative¹⁵— state intervention in the sphere of private law, and an exercising of state control¹⁶ or influence. However, this

⁸ B Orbach, *What is Regulation?* 30 *Yale Journal on Regulation Online* (2012).

⁹ A Beattie, *The Pitfalls of Financial Regulation* <<http://www.investopedia.com/articles/economics/10/pitfalls-financial-regulation.asp>>.

¹⁰ R Baldwin, M Cave and M Lodge (n 4) at 3-4; Baldwin, Scott, Hood, *Regulation*, Ch. 1; A Ogus, *Regulation: Legal Form and Economic Theory* (Oxford, 1994); J Black, *Decentering Regulation: Understanding the Role of Regulation and Self-Regulation in a “Post Regulatory” World* 54 *Current Legal Problems* 103-47; J Black, *Critical Reflections on Regulation* 27 *Australian Journal of Legal Philosophy* 1-95 (2002); D K Smith, *What is Regulation?* 27 *Australian Journal of Legal Philosophy* (2002); BM Mitnik, *The Political Economy of Regulation*, Ch. 1 (New York, 1980); G Majone (ed), *De-Regulation or Re-Regulation?* (London, 1989).

¹¹ A Ogus, *Regulation: Legal Form and Economic Theory* (Oxford, 1994).

¹² S Breyer, *Regulation and its Reform* (Cambridge, MA, 1982); A Ogus (n 10), Ch. 1, 1; R Baldwin, *Regulation: After Command and Control* in K Hawkins (ed.), *The Human Face of Law* (Oxford, 1997).

¹³ P Selznick, *Focusing Organisational Research on Regulation* in R Noll (ed.), *Regulatory Policy and the Social Science*, 363 (Berkeley, C.A., 1985).

¹⁴ R Baldwin and M Cave (n 4), 4.

¹⁵ C Harlow and R Rawlings, *Law and Administration* (3rd edn, Cambridge, 2009); Ogus, *Regulation* (n 9).

¹⁶ *Black’s Law Dictionary*, 1311 (9th edn, 2009). *Black’s Law Dictionary* defines regulation as ‘the act or process of controlling by rule or restriction’. A similar definition of regulation as ‘to control, govern, or direct’ is found in *The Oxford Dictionary*. The main theme in the above efforts to define regulation is that it is an act of controlling behaviour.

theme is rather comprehensively captured by the term ‘influence’ in Baldwin and Cave’s definition of regulation as ‘deliberate state influence’.

The apparent confusion about the nature of the term ‘regulation’ is largely due to the abstract concept it denotes.¹⁷ The confusion is compounded when the concept is explored in other disciplines such as politics, sociology and economics. In these contexts, regulation becomes a highly contested concept. It is seen by the political right as the tool of authoritarian government, and by the left as a structure to support the interests of the dominant class. Democrats see it as a public good¹⁸ which allows the control of myriad societal risks from welfare to ecology by distribution of wealth.¹⁹ For economists, it amounts to an instrument of exploitation used by private interests.²⁰ However, this research focuses exclusively on regulation within the legal context.

The definition of regulation can also be determined by understanding the conceptual difference between law and regulation. Laws are normative in nature, based on societal norms and enforced by the judiciary. Private law (e.g. contract and tort) are based on legal norms interpreted and developed by the courts, and are thus a judge-made or common law. The law is there to protect property rights and rights in general. It protects property from transgressors such as thieves and fraudsters, and defines the boundaries of property so that legitimate disputes can be settled through litigation, under contract and tort law. Thus, law is all about safeguarding rights.

Regulation, on the other hand, is not primarily about rights; it is about prescribing the behaviour of people, economic activities, and activities in general. It controls what one should or should not do, irrespective of one’s rights and irrespective of property. By definition, most regulations (not all) are preclusive in nature. They preclude individuals from acting in a certain way either to achieve the government’s desired outcome or to avoid any undesirable consequences. Regulations are not there to protect rights, and indeed some have argued that by their very nature they are a violation of individual rights. They interfere with people’s ability to live freely and to deal with their property as they see fit. Regulations are written rules (legislation) as opposed to legal norms or principles of law found in court judgements. Regulation is mandatory in nature and must be followed by everyone whereas application of law can be agreed between the parties, under the principle of freedom of contract, and followed. So the regulation displays *state power* as opposed to law which is normative, showing that the origins of law and regulation are different. In this sense, all primary as well as

¹⁷ Barak Orbach (n 7) at 3.

¹⁸ See generally J Braithwaite, *Crime, Shame and Reintegration* (Cambridge, 1989); Braithwaite, *Restorative Justice and Responsive Regulation* (Oxford, 2002); I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford, 1992).

¹⁹ D Levi-Faur, *Regulation and Regulatory Governance, Jerusalem Paper in Regulation and Governance*, Working Paper no.1 (February 2010).

²⁰ GJ Stigler, *The Theory of Economic Regulation*, *Bell Journal of Economics and Management Science*, 2, 3-21 (1971); GA Jarrell, *The Demand for State Regulation of the Electric Utility Industry* 21 *Journal of Law and Economics* 269-96 (1978); G Priest, *The Origin of Utility Regulation and the “Theories of Regulation” Debate* 36 *Journal of Law and Economics* 289-324 (1993).

secondary legislation can be defined as *regulation*. From a legal perspective, a statute enacted by a legislature is understood to be a paradigmatic form of regulation.²¹

However, this strong argument could be countered by the argument that regulation actually reorganises private rights and obligations, and by doing so it prioritises rights and obligations and thus overrides private law by being a public law.

In essence, this means that any state-made law, as opposed to any general, traditional or normative law such as the common law, civil law or laws of other legal traditions such as the Chinese or Russian legal traditions, is a regulation. Thus it may be conceptualised that regulation is a state action in the form of a legal instrument made by a government or a public body that is designed to influence the behaviour of persons, either natural or legal, that is valued by the community.

C. Market Failure: An Economic Perspective

i. *The Concept of 'Market Failure'*

The need for regulation arises when there is a *market failure*; this is the rationale most often presented for regulation.²² Market failure means “*a circumstance where the pursuit of private interest does not lead to an efficient use of society’s resources or a fair distribution of society’s goods*”.²³ Put another way, it means when a particular market “*fail[s] to produce behaviour or results in accordance with the public interest*”.²⁴ It can also be described as a situation where the allocation of goods and services by a free market is not efficient.²⁵ In simplest terms, it means the existence of an unfair market place, which prevents an efficient outcome. An efficient market makes a market participant better-off without making someone else worse-off.²⁶

The concept of market failure originally developed in relation to the question of the proper role of the state in the market place; governments struggled to decide which services the state should provide or how it should regulate the activities of individuals and firms.²⁷ In this regard, the concept of market failure provided itself as an

²¹ B Morgan and K Yeung, *An Introduction to Law and Regulation: Text and Materials*, 4 (Cambridge, 2007).

²² See R Baldwin and M Cave (n 4) at 16-22.

²³ DL Weimer and AR Vining, *Policy Analysis: Concepts and Practices*, 13 (2nd edn, Englewood Cliffs, NJ, 1992); See also D MacRae and JA Wilde, *Policy Analysis for Public Decisions*, 170 (Lanham, MD, 1985); EK Browning and JM Browning, *Microeconomic Theory and Applications*, 657 (4th edn, New York, 1992); Boardman et al., *Cost-benefit Analysis: Concept and Practice*, 99 (Upper Saddle River, NJ, 1996).

²⁴ R Baldwin and M Cave (n 9), Ch. 1.

²⁵ R Cooter, *Normative Failures Theory of Law* 82 *Cornell Law Review* 947, 945 (1996).

²⁶ This outcome is contrary to Pareto optimality; where Pareto is of the view that no one can be better off without making some other individual worse off.

²⁷ RO Zerbe Jr and HE McCurdy, *The Failure of Market Failure* 18 *Journal of Policy Analysis and Management* 559.

objective standard by which such decisions can be made.²⁸ Originally, the concept of market failure was used only as a normative concept to define appropriate circumstances for government intervention in markets, meaning in economic terms, why the necessity for public intervention should arise.²⁹ Later on, as the concept of market failure matured, it was also viewed as a diagnostic tool by which policy makers could understand how to objectively determine the exact scope and type of intervention.³⁰ Hence, Joseph Farrell alludes: *'The welfare theorem lets [us] classify inefficiencies as due to monopoly externalities, and so on. This helps us to understand and perhaps to solve such inefficiencies just as a doctor's diagnosis ... is part of treatment'*.³¹ The diagnostic approach consisted of a double market failure test to identify the types of problems that cause market failure, as well as the bureaucratic malfunctions and non-market failures that are likely to occur.³² Thus the concept of market failure was used by public officials³³ to determine the proper role of the state in a marketplace.³⁴

ii. Instances of Market Failures

In a society there are many types of market failure in all walks of life, for example market failure occurs where monopolies exist because competition is deficient. Monopolies exist when one company produces for the entire market.³⁵ There are no substitutes available to consumers and there are high barriers for new entrants to the market.³⁶ In such conditions, the producer will restrict its output and increase prices above marginal cost to maximise profits. This consequently damages public interests, leaving the consumer worse off. Regulation can introduce competition in monopolised

²⁸ *Ibid.*

²⁹ *Ibid.* See also, CJ Dahlman, *The Problems of Externality* 22 (1) *Journal of Law and Economics* 143 (1979); AC Pigou, *The Economics of Welfare*, 173 (4th edn, London, 1932); P.A Samuelson, *The Pure Theory of Public Expenditure* 36 *Review of Economics and Statistics* 388; NT Skaggs and JL Carlson, *Microeconomics: Individual Choice and its Consequences*, 543 (2nd edn, Cambridge, MA, 1996).

³⁰ RO Zerbe Jr and HE McCurdy (n 27); See also DL Weimer and AR Vining (n 23); Boardman et al. (n 23); DN Hyman, *Public Finance: A Contemporary Application of Theory to Policy* (Chicago, 1990); U Procarcia, *Crafting A Corporate Code from Scratch* 17 *Cardoza Law Review* 629-645; J Farrell, *Information and the Coase Theorem* 1 *Journal of Economic Perspectives* 113-129.

³¹ *Ibid.*

³² DL Weimer and AR Vining, (n 23), 179.

³³ LD Alessi, *Error and Bias in Benefit-Cost Analysis: HUD's Case for the Wind Rule* 16 *Cato Journal* 129 (1996).

³⁴ DL Weimar and AR Vining (n 23), 13: "[W]hen is it legitimate for government to intervene in private affairs? In the United States, the normative answer to this question has usually been based on the concept of market failure - ..."

³⁵ Gellhorn and Pierce (n 21), 36-37; See generally, Ogus (n 10), 30-3; Breyer (n 11), 15-19; Foster C, *Privatisation, Public Ownership and the Regulation of Natural Monopolies*, Ch. 6 (Oxford, 1992); Francis, *Politics of Regulation*, Ch. 3; E Gellhorn and W Kovacic, *Antitrust Law and Economics*, chs 3 and 4 (St Paul, Minn., 1994).

³⁶ See generally C Foster (n 35), Ch. 6; Gellhorn and Pierce (n 21), 36-37; R Baldwin and M Cave (n.4), 16-18; Ogus (n 10), 30-33; Breyer (n 11), 15-19; E Gellhorn and W Kovacic (n 35), chs 3 and 4; Francis (n 21), Ch. 3.

markets. Except where natural monopolies exist³⁷ and producers will serve consumers at least cost,³⁸ the common response to monopolies is to use competition law³⁹ (regulation) to create a fair market for competition.⁴⁰

The other commonly cited examples of potential market failure include: externalities⁴¹ such as pollution and systemic risk in the banking industry and so need to be regulated because the price of a product does not reflect the true cost to society of producing that product;⁴² windfall profits that are not a result of planned investment;⁴³ and information inadequacies where markets are distorted and not enough information is available to evaluate competing products. All those myriad instances where insufficient information might damage consumer interests necessitate some level of market regulation.⁴⁴ Keynes pointed out factors⁴⁵ such as imperfect information,⁴⁶ economies of scale, inequality of income, external economies, adjustment lags, and indivisibility of production as representing unfair markets.⁴⁷ One may also add to this non-exhaustive list the other commonly cited examples of potential market failure including anti-competitive behaviour, predatory pricing, non-availability of services in remote areas,⁴⁸ public goods, the moral hazard⁴⁹ scenario (free riders), and unequal bargaining power.⁵⁰

iii. Market Failures are Ubiquitous

Theoretically, the concept of market failure provides a rationale for unlimited government intervention, meaning that state intervention is justified or it must intervene whenever there is a market failure. It appears to provide a normative explanation for state intervention, but in reality it is not a 'normative' concept as it describes a situ-

³⁷ Competition is undesirable in such circumstances as it will introduce social costs and go against public interest; regulation of prices, quality, output level and access are preferable. See Ogus (n 10) 31; G Yarrow, *Regulation and Competition in the Electricity Supply Industry* in J Kay, C Mayer, and D Thompson (eds), *Privatisation and Regulation* (Oxford, 1986).

³⁸ M Waterson, *Regulation of the Firm and Natural Monopoly*, Ch. 2 (Oxford, 1988); Foster, *Privatisation* (n 36), Ch. 6.2.

³⁹ In the case of 'natural monopoly', however, competition law is not desirable. On natural monopolies, see M Waterson (n 38), Ch. 2; Foster (n 38).

⁴⁰ See also, Ogus (n 10), 31; G Yarrow (37).

⁴¹ CJ Dahlman (n 29), 141, 143.

⁴² The rationale of regulation in this context is to reduce 'overconception' and protect the environment by forcing the polluter to pay the actual price. See Ogus (n 10), 35-8; Breyer (n 11), 23-6.

⁴³ Breyer (n 11), 21.

⁴⁴ F Hayek, *The Use of Knowledge in Society* 35 *American Economic Review* 519 (1945); Ogus, *Regulation*, 38-41; Breyer, *Regulation and its Reform*, 26-8.

⁴⁵ FH Knight, *Laissez-faire: Pro and Con* 75 (6) *Journal of Political Economy* 782 (1967).

⁴⁶ See F Hayek (44); Breyer (11), 26-8; Ogus (10), 38-41.

⁴⁷ See generally JM Keynes, *The End of Laissez-faire: The Economic Consequences of the Peace* (first published 1926; BN Publishing, 2009).

⁴⁸ See generally Baldwin and Cave (n 4), 16-22.

⁴⁹ G Calabresi, *The Cost of Accidents: A Legal and Economic Analysis* (New Haven, 1970).

⁵⁰ E.g., collective bargaining agreement.

ation that is ubiquitous; market failures happen all the time and are everywhere. This will lead to ambiguous conclusions. Market failure, as a rationale for regulation, is only true in the case of significant failures. Empirical evidence also suggests that government intervention is only optimal when a significant market failure occurs.⁵¹ The existence of an externality is a necessary but not sufficient condition for state intervention, and it cannot be assumed that government intervention is warranted in all cases of market failure.⁵² Market failure per se is not a precondition to intervention. In terms of efficiency, regulation should only arise where the cost of regulation is less than the benefits. In this context, a cost benefit analysis should provide clear guidance. Thus, normatively and empirically, the concept of market failure is flawed. However, it is important to emphasise that significant failures do justify public intervention, such as regulation.

iv. *The Concept of 'Transaction Costs' and Property Rights; and Market Failures*

Coase sees externalities through his so-called 'Coase theorem', where all rights are defined and parties can negotiate their rights and reach a conclusion through a bargaining process. In this contractual process, he sees issues settled on the basis of transaction costs⁵³, which obviate the need for the search of market failures and hence the need for regulation. In economics, a transaction cost is defined as the cost of participating in a market place – in other words, a cost incurred in making an economic exchange. Broadly these costs are the resources necessary to transfer, establish and maintain property rights. Property rights are theoretical structures in economics for establishing how a resource (property) is owned and used.⁵⁴ Property refers to ownership, which entails rights to the proceeds generated by a property and control over a resource or good (property). Hence, property rights can be viewed as an attribute of an economic good (property); this attribute has four broad components and is often referred to as a *bundle of rights*, or rights inherent with the property. These four rights are (1) the right to use the good; (2) the right to earn income from the good; (3) the right to transfer the good to others; and (4) the right to enforcement of property rights.

Market failures (externalities) are actually transaction costs. If transaction costs are imposed through law (contract and tort) then externality will be zero, and therefore

⁵¹ PA Samuelson, *Economics: An Introductory Analysis*, 45,159 (6th edn, New York: McGraw Hill 1964); RH Coase, *The Lighthouse in Economics* 17 *Journal of Law and Economics* 357-376, 364, 366 (1974); MA Zupan, *Are Public Goods Good for the Public?* Working Paper, University of Southern California Business School, Los Angeles, California (1996); A Randall, *The Problem of Market Failure* 23 *Natural Resources Journal* 131-148, 147; AG Pigou (n 29), 174; SNS Cheung, *The Fable of the Bees: An Economic Investigation* 16 *Journal of Law and Economics* 11-33, 16 (1973); SNS Cheung, *The Theory of Share Tenancy*, 56-61 (Chicago, 1969); HS Gordon, *The Economic Theory of a Common Property Resource: The Fishery* 62 *Journal of Political Economy* 124-142.

⁵² U Procaccia, *Crafting a Corporate Code From Scratch* 17 *Cardozo Law Review* 629 (1995).

⁵³ RH Coase, *The Nature of the Firm* (1937). Reprinted in R Coase, *The Firm, the Market, and the Law* (Chicago, 1988).

⁵⁴ RH Coase, *The Problem Of Social Cost* 3 *Journal of Law and Economics* 1-44 (1960).

no market failure can occur. The non-enforcement of the transaction costs by law (tort, contract and criminal law) is actually a failure of law rather than the market. Ideally there should be no circumstances where an externality could be outside the scope of law or regulation unless there is a subversion of justice.

In reality, externalities exist because the transaction costs for resolving a dispute are too high. For example, environmental regulations are designed to overcome resistant negotiators, where negotiations between developers and local communities resistant to site facilities, such as landfill, can be characterised as contracting issues and can fail because of the high transaction costs insisted upon by the resistant negotiator. As a result, the bargaining will halt because of the high transaction cost.⁵⁵ Such a dispute reveals the dynamics that foil bargaining processes, which requires regulation to be implemented.⁵⁶ Transaction cost analysis is significant in the context of cost benefit analysis to achieve the optimum outcome in regulatory terms.

D. Theory of Subversion of Justice: One Theory of Regulation

i. Emergence of an Alternative Mechanism

A fundamental theoretical departure may be made from the economic argument for the emergence of regulation (market failure), to the legal argument (that regulation arises because of a subversion of justice, inefficiency or inadequacy of common law). It actually arises for reasons embedded in justice and fairness. 'Regulation' is essentially a legal phenomenon and as a result it must have its explanation in legal jurisprudence. 'Market failure' is essentially a concept which is entrenched in the discipline of economics, not law. The economic argument is therefore essentially an economist's perception of regulation and has little to do with the analysis of the concept of regulation as a legal phenomenon in its origins in social settings.

Private relationships between parties were primarily dealt with in accordance with the rules of private law, i.e. contract and tort law. Hence commercial disputes were generally resolved through private litigation. For example, in the US, a country which has been at the forefront of developing regulation, before the nineteenth century the courts decided upon cases of corporate liability in industrial accidents, on anti-competitive practices, safety of foods and medicines and so on. However, over three decades, roughly from 1887 to 1917, this whole situation changed because of the so called 'Progressive Era', which introduced the landmark Interstate Commerce Act along with other kinds of regulation.⁵⁷ Regulation emerged as an alternative mechanism and the nineteenth-century belief that private litigation was the only appropriate

⁵⁵ BD Richman and C Boerner, *A Transaction Cost Economizing Approach to Regulation: Understanding the NIMBY Problem and Improving Regulatory Responses* 23 *Yale Journal on Regulation* 29-76 (2006).

⁵⁶ *Ibid.*

⁵⁷ See generally R Hofstadter, *The Age of Reform* (New York, 1955).

response to social wrongs was chipped away.⁵⁸ Regulation was brought in as an alternative to civil law.⁵⁹ During the progressive era, regulatory agencies took over the social control of food and drug safety, competition policy, rail road pricing and so on.

Although Britain has the earliest history of regulation, it has not been discussed extensively in a theoretical framework, such as the analysis of the subversion of justice and failure of common law or in an economic theoretical perspective. An area that would merit closer investigation would be the Regulation of Railways Act 1844, which dealt with pricing and safety issues and by doing so had overridden the common law principles of contract and tort law for the sake of efficiency, owing to its vulnerability to market place. Between 1844 and 1923, regulation emerged as a comprehensive regulatory regime which had developed to tighten railway safety and prices/rates.⁶⁰ The 1844 Act actually shaped the US 1887 Interstate Commerce Act, which in turn shaped subsequent regulation in the US.⁶¹

The central issue is why this change happened or why contract or tort law could not successfully address the problems of the Progressive Era or eighteenth-century UK industrialisation of society.⁶² The answer to these questions lies in the discussion of the choice between litigation over damages and regulation in terms of efficiency.⁶³

ii. *Subversion of Justice*

Subversion of justice occurs when law (in particular contract and tort law) fails to protect the functioning of markets efficiently. The purpose of private law is to facilitate private relations between private parties e.g. in contract law. However, such facilitation of private bargaining in a market may stumble upon difficulties.⁶⁴ To deal with problems, new regulations are introduced.

⁵⁸ EL Glaeser and A Shleifer, *The Rise of the Regulatory State* XLI Journal of Economic Literature 401 (June 2003).

⁵⁹ Expropriation and distribution of wealth by kings or dictators by fiat is not regarded as regulation, therefore does not form the part of the discussion.

⁶⁰ I McLean, *The Origin and Strange History of Regulation In The UK: Three Case Studies in Search of Theory*, Paper for ESF/SCSS Exploratory Workshop: The Politics of Regulation, Barcelona, November 2002, at 7, 4-17, at <<http://www.nuffield.ox.ac.uk/politics/papers/2002/w29/The%20origin%20and%20strange%20history%20of%20regulation%20in%20the%20UK.pdf>>, accessed on 03/04/2015; on Victorian regulation, see generally G Alderman, *The Railway Interest* (Leicester, 1973); Foster, *Privatization, Public Ownership and the Regulation of Natural Monopoly* (Oxford, 1992); TR Gorvish, *Mark Huish and the London and North Western Railway* (Leicester, 1972); WC Lubenow, *The Politics of Government Growth: Early Victorian Attitudes towards State Intervention 1833-1848* (Newton Abbot, 1971); H Parris, *Government and the Railways in the 19th Century* (London, 1965); PM Williams, *Public Opinion and the Railway Rates Question in 1886* 67 English Historical Review 37-73 (1952).

⁶¹ S Breyer (n 11), 6, 199; TK McCraw, *Prophets of Regulation* (London, 1984).

⁶² R Coase (n 54).

⁶³ R Posner, *Economic Analysis of Law* (5th edn, Boston, 1998); S Shavell, *A Model of the Optimal Use of Liability and Safety Regulation* 15 Rand J. Econ. 271-80 (1984).

⁶⁴ EL Glaeser and A Shleifer (n 58), 401.

Litigation (contract and tort disputes) and regulation are two alternative institutional arrangements to secure property and rights in general. The assumption is that whatever law enforcement strategy a society chooses, private individuals will seek to subvert any institutional arrangement, common law or otherwise in place to secure property or rights in general to benefit themselves, and more aptly to benefit themselves unfairly.⁶⁵ Therefore, the law becomes inefficient. The necessity of regulation arose because of the subversion of justice; this theory is vividly displayed in the rise of the regulatory state in modern times. Subversion of justice, during the late eighteenth-century industrialisation of society, exposed the inefficiency of common law. Regulation emerged to solve the societal problems that consequently caused market failures.

Subversion here means a number of both legal and illegal strategies.⁶⁶ Legal subversion, for example, includes delaying tactics in a court case (contract or tort) or making justice exorbitantly expensive for a weaker party through better lawyers, lobbying for the appointment of favourable judges, and influencing the legislative process to acquire favourable legislation and regulations and so on. Illegal subversion includes intimidating and bribing law enforcers, judges, regulators, police, and juries and so on. By utilising enough resources, law violators can get away with simply having to pay regulatory fines and liability payments.

However, the efficiency of alternative institutional arrangements in part depends on their vulnerability to such subversions of justice.⁶⁷ Vulnerability means susceptibility or weakness of law vis-à-vis individual self-interest. A private individual's subversive self-interest in these contexts is always a threat to the workings of the law. The problem with the free market model is that it assumes that there is such a thing as a perfect market, which is impossible to achieve.⁶⁸ It does not take into account myriad factors such as dishonesty, embezzlement, greed or human error, which are highlighted by Keynes.⁶⁹ The reason that private law could not successfully address the problem is due to the inherent vulnerability of law to the subversive ability of individuals' selfish and unfair interests. Without the utopian concept of the 'perfect market', the law is unable to protect property rights and rights in general in absolute terms.

The industrialisation of society in the nineteenth century created the circumstances in which the common law system of justice became vulnerable to subversion. Litigation (liability-damages) was no longer an efficient mechanism to solve societal problems. As the industrialisation of the economy in the later part of the nineteenth century took hold, it created companies with vast resources. Along with the size of the enterprises, damage from accidents also increased. However, the cost of subverting justice

⁶⁵ *Ibid.*

⁶⁶ *Ibid.* at 402.

⁶⁷ *Ibid.*

⁶⁸ I Katsuhito, *The Second End of Laissez-faire: The Bootstrapping Nature of Money and the Inherent Instability of Capitalism* in H Ganssman, *New Approaches to Monetary Theory: Interdisciplinary Perspective*, 237 (Abingdon, 2011).

⁶⁹ M Keynes (n 47).

in relative terms did not rise much for the big enterprises. Therefore the incentive to avoid paying for liabilities also increased; in this scenario, the law became more vulnerable to subversion. Smaller businesses or individuals working in these enterprises had little chance of prevailing against them in the case of an accident, restraint of trade or discriminatory practice. From this perspective, the regulation of the markets was an appropriate response to the ineffectiveness of litigation as a mechanism of social control of business.⁷⁰ It highlighted the inefficiency of the common law. This structural change in the market place increased the vulnerability of the private law and made it more efficient for American society to rely increasingly on regulation than on litigation.⁷¹ Woodrow Wilson highlighted the phenomenon of subversion of justice when he said, “the laws of this country do not prevent the strong from crushing the weak”.⁷² The subversion of justice⁷³ and the inefficiency of the common law mechanism of litigation created market failures of various sorts, which paved the way to a fundamental change to make it efficient by relying on regulation.

Society must choose between private enforcement (litigation) and/or regulation to seek justice. Too much, frequent and protracted litigation might seem an efficient enforcement of liabilities, but in reality the efficiency becomes victim of this excessive activity (subversion of justice). In such circumstances, less litigation and more regulation will achieve better outcomes in terms of efficiency. For example, the fixed cost of lawsuits is a potential argument in favour of enforcement through regulation as opposed to private law.⁷⁴ This argument highlights the inherent drawback of litigation.⁷⁵ From the efficiency perspective, in certain circumstances regulation emerges as a better choice to deal with tort and contract problems. The overwhelming ‘transaction costs’ become the determining factor for a choice between common law and regulation⁷⁶ however, this does not mean that the regulation itself is devoid of problems, it can also fall victim of inefficiency⁷⁷. Thus, it may be determined that legal or illegal subversions, whether through transaction costs or otherwise, would cause unfair situations and consequently the emergence of regulation.

⁷⁰ EL Glaeser and A Shleifer (n 58), 402.

⁷¹ *Ibid.*

⁷² W Wilson, *The New Freedom*, 15 (New York, 1913).

⁷³ EL Glaeser and A Shleifer (n 58), 402. According to Glaeser and Shleifer, an invulnerable justice system, where law and order are strong would not require any regulation. Where law and order are intermediate, the justice system will be vulnerable to some extent and there will be a need for some regulation and the enforcement of common law. However, where the justice system is most vulnerable, meaning where there is a very little law and order, there is a need of more for regulation.

⁷⁴ Posner (n 63).

⁷⁵ Shavell (63).

⁷⁶ R Coase (n 54), 1-44; R Posner (n 63); S Shavell (n 63), 271-80. See also Shavell Steven, *Liability for Harm Versus Regulation of Safety* 13 J. Legal Studies.354-74 (1994); also S Shavell (n 63)

⁷⁷ See G Stigler(n 19); R Posner (n 63). This view is advocated by the ‘capture’ and ‘special interest’ theories of regulation. According to these theories, regulation is sought by interest groups in order to restrain competition, particularly from groups that hold an upper hand in the field of technology.

E. Inherent Inefficiency and Inadequacy of Common Law

A legal framework where markets operate without regulation has two important aspects to be considered.⁷⁸ The first is the structure and operation of the market itself; second are the transactions taking place in the market.⁷⁹ These are two distinctive things. From a structural and operational point of view, an unregulated market will allow free access to the market place to all kinds of buyers and sellers, meaning that there is no licensing or authorisation requirements for the market participants for a particular market activity. Unrestricted access to a market may cause market failure if unscrupulous and unqualified individuals are allowed to practice.⁸⁰ For example, a banking institution should only be allowed a licence to practise if it fulfils certain criteria, which will generate confidence and trust in the market. This trust is important as individual customers have no way of finding out whether an institution is credible or not, and they must be confident that their rights are well protected – a phenomenon seen in the cases of PP protection in UK.

The second aspect of the legal framework is the administration of *transactions* in the market. Property, contract and tort law are necessary components of this legal framework; together they define ownership interests and their mode of transfer.⁸¹ In many cases, a market can work successfully on the basis of general principles of commercial law and tort without the assistance of any regulatory regime, simply because the law is sufficiently developed in that particular area to take care of certainty of ownership interests and their transfer, and to check for fraud and the protection of private rights. However, an unregulated market can also present potential problems; this is where regulation becomes a necessity.⁸²

The obvious scenario is where there is no control on the terms that may be agreed between contracting parties; the party with a weaker bargaining position may not have much choice but to accept a bad bargain. Such a situation has long been viewed as unfair; however, more importantly in the present discussion this has been interpreted as an inefficient market because it is more likely to inhibit contracting between the parties and consequently the process of investment. Regulatory rules are mandatory in nature; they must be observed and cannot be excluded by agreement between parties. These rules differ fundamentally from the rules of contract law (common law) which are default rules, meaning that they can be altered by express agreement between the contracting parties, whereas regulatory rules cannot be circumvented.⁸³ The noticeable example of regulatory rules is The Unfair Contract Terms Act 1977.⁸⁴

⁷⁸ IG MacNeil, *An Introduction To The Law on Financial Investment*, 28 (2nd edn, Oxford, 2012).

⁷⁹ *Ibid.*

⁸⁰ R Baldwin and M Cave (n 4), 16.

⁸¹ IG MacNeil (n 78), 28.

⁸² See generally Ogus (n 10), chs 3 and 10.

⁸³ IG MacNeil (n 78), 28.

⁸⁴ Older examples are common law restraints over freedom of contract. See also s 232, the Companies Act: it makes void any contract that exempts or restricts the liability of a director to a company for breach of duty.

Thus the term ‘regulation’ in its technical meaning simply means that regulatory rules are mandatory, which prohibit or limit the operation of general rules of contract law or private law for that matter. Also, in common parlance, the term ‘regulation’ refers to rules and procedures created by statute. Thus, private law has embraced regulatory rules along with the general law. Thus, emergence of regulation is caused by two factors, namely inefficiency of common law and the subversion of common law.

The rationale for regulation is that general commercial law (private law) and, in particular, contract law and property law fail to offer an adequate basis for the proper functioning of the markets due to the legal or illegal subversion of the civil law.⁸⁵ Thus regulations are differentiated from the general law (e.g. common law or civil law) and are introduced when general law fails to resolve a problem fairly and when only government intervention (public regulation) will resolve the problem and correct the unfair situation to control and guide the economy and society. It includes all kinds of legislation (regulation), be it primary, secondary or tertiary. Regulation comprises not only rulemaking but also rule monitoring and enforcement.⁸⁶

Furthermore, regulation emerges not only as a result of the subversion of justice (subversion of contract or tort law) but also because of inadequacies in private law (common, tort and contract law). Regulation emerges as a mechanism to deal with circumstances in which common law and private law are found inadequate, in other words deficient, to restore injustice.

F. Rights and Justice, and Inadequacy of Private Law

The emergence of regulation is inconceivable without the analysis of fundamental concepts of rights and justice. Rights are a central concern of jurisprudence and justice is a universally praised virtue of a legal system that transcends law itself.⁸⁷ Beyond the subversion of existing rights, individuals are asserting new rights, exposing the inadequacy of the present private law regime. The idea of rights stands on the claim that we as human beings are entitled to certain fundamental and inalienable rights merely by virtue of being human; whether these rights are legally recognised is immaterial. The question, what is a right, can be answered in two ways. There are rights that are recognised by law and there are rights that one ought to have. A right is defined as the protection of a legitimate interest. An ‘interest theory’ of rights obliges us that if there is an interest, not protected by law, then a law should protect it.⁸⁸ Such protection of interests has nothing to do with market failure; rather it is a fundamental normative principle that certain interests in certain circumstances need to be protected through the emergence of new regulation. This protection of interests

⁸⁵ IG MacNeil (78), 19-21 & 27-31.

⁸⁶ C Hood, H Rothstein and R Baldwin, *The Government of Risk: Understanding Risk Regulation Regimes* (2001).

⁸⁷ R Wacks, *Philosophy of Law*, 65 (Oxford, 2014).

⁸⁸ *Ibid.* at 66.

through regulation is warranted in the wake of subversion of justice (failure of private law to protect rights) as well as by creating new rights on the basis of justice and fairness; for example, social rights, such as some environmental and human rights,⁸⁹ may not currently be legally protected in a particular jurisdiction.

In mankind's relatively recent history, the protection of legitimate interests of humans through law and public regulations can be discerned in three stages.⁹⁰ The first stage is in the form of negative civil and political rights, which bear the mark of Hobbs, Lock and Mills; their emphasis is on the prohibition of interference with right-holders freedom. The second stage consists of positive rights, such as the right to education and medical care. The third stage emphasises collective rights. These 'social solidarity' rights run alongside legitimate human concerns.⁹¹ They concern human social and economic development involving benefits from earth and space resources, windfall profits that did not happen because of a planned business effort but as a natural phenomenon, the right to healthy environment, and so on. Regulation emerges in such areas as these where private law could be found inadequate and deficient and where only regulation would resolve injustice.

This leads us to Aristotle's assertion that justice consists in treating equals equally and unequals unequally, in proportion to their inequality. In this vein, the development of 'social solidarity' rights rests upon 'distributive' justice,⁹² which allows each individual what is due to them according to what they deserve. Distributive justice is the concern of public regulation – how society should most fairly distribute the benefits of social life is a true reflection of utilitarianism. On the other hand, whether law and economics or economic factors play a significant role in decisions of the courts is not without controversy. The idea behind economic analysis of law (Coase's theorem) is the maximisation of wealth – the same as utilitarianism. Maximisation of wealth in itself as a 'value' is unlikely to be traded against justice; this would be an oversimplification of 'individual choice' – an ideological tilt towards excessive capitalism and the free-market with little to do with justice or distributive justice.⁹³ Although Coase presupposes original distribution of wealth, it may not necessarily be 'distributive justice'. In such circumstances, regulation could be justified. The late nineteenth-century industrialisation of society proved that increased wealth and power often lead to subversion of private law. The outcomes of litigation during this period were profoundly different than those envisaged by Coase in his theorem. His transactions costs theory does not figure in the reality of subversion of law; rather it is focussed on the allusive concept of the 'perfect market'.

John Rawls' theory of justice – the concept of justice as fairness – is the most relevant idea in relation to the rationale for the emergence of regulation. Utilitarianism *per se* does not provide a benchmark for justice. For Rawls, maximum welfare (util-

⁸⁹ T Prosser, *Regulation and Social Solidarity* 33 *Journal of Law and Solidarity* 364 (2006).

⁹⁰ R Wacks (n 87), 70-71.

⁹¹ T Prosser (n 89), 364.

⁹² Aristotle distinguishes between 'corrective' and 'distributive' justice.

⁹³ R Wacks (n 87), 70-71.

itarianism) is unacceptable if it causes inequality; for him, the subject of justice takes priority over happiness, meaning that a particular happiness also has to be just in the first place; therefore he calls justice fairness. Rawls' theory is deeply rooted in the idea of the social contract theorised by Hobbes, Locke and Rousseau, as an abstraction of a higher level, embedded in principles of justice.

It transpires that regulation does not deal with market failures.⁹⁴ Rather, it deals with the subversion or absence of justice.⁹⁵ It is underpinned by social justice and fairness, which may be explained by social theory. Regulation is primarily a social phenomenon.⁹⁶ It inspires us to think 'what kind of society do we want to be' and 'what is good for us all'.⁹⁷ The rationales for regulation are embedded in constitutional norms.⁹⁸ Regulation as a public intervention is to deliver social purpose and social justice. This idea of regulation may be found in the civil law system in the form of 'implementing values of public service and as providing a contribution to social solidarity'.⁹⁹ It can be argued that in the face of subversion of justice or unjust circumstances or unfairness, the emergence of regulation is a political response to maintain ideas of justice and fairness.¹⁰⁰ Indeed, Adam Smith saw "*a tolerable administration of justice*" as a proper function of government for the sake of fairness.

G. Regulatory Intervention: Political Perspective

In the context about the necessity of regulation, we once again ask what 'regulation' means. Based on the above analysis of the term 'regulation', intuitive understanding of the term is that it is a government *intervention* in the private domain to shape the

⁹⁴ See A Pigou (n 29); J Stiglitz (n 9).

⁹⁵ EL Glaeser and Andrei Shleifer (n 58), 40-42.

⁹⁶ Cf. A Ogus (n 10) 4, 46-56. While Ogus accepts 'market failure' analyses, he also accepts distributional justice and community values. See also, Baldwin and Cave (n 4), 22-23. They accept distributional justice and social policy as rationales for regulation; S Breyer (n 11), 15-35: Along with 'market failure', they accept fairness and distributional justice as rationales for regulation; J Black, *A Critical Reflections on Regulation*, LSE Centre for the Analysis of Risk and Regulation, Discussion Paper 4 (2002) at 7.

⁹⁷ J Black, *Proceduralising Regulation – Part I* 20 Oxford Journal of Legal Studies 597-614 (2000), and *Part II* 21 Oxford Journal of Legal Studies 33-58, 59 (2001). See also C Sunstein (n 21), 229. In respect of reliance on neoclassical economics, Sunstein states that it "cannot capture the diverse legitimate reasons for regulatory controls".

⁹⁸ C Sunstein (n 21), 231.

⁹⁹ T Prosser (n 89), 364, 378. See generally C Graham and T Prosser, *Privatizing Public Enterprises – Constitutions, the State and Regulation in Comparative Perspective* (Oxford, 1991); L Duguit, *The Law and the State* 31 Harvard Law Review 183-4 (1917); See also T Prosser, *The Regulatory Enterprise: Government Regulation and Legitimacy*, 11-12 (Oxford, 2012), where Prosser indicates four rationales for regulation: (1) regulation for economic efficiency and consumer choice – this is market-centred regulation; (2) regulation to protect rights; (3) regulation for social solidarity; and (4) regulation as deliberation (meaning, the provision of process to resolve problems). See also J Black, *Critical Reflections on Regulation* (n 96); H.McVea, *Financial Services Regulation Under the Financial Services Authority: A Reassertion of the Market Failure Thesis?* 64 Cambridge Law Journal 413-48 (2005).

¹⁰⁰ See generally, J Landis, *The Administrative Process* (New Haven: Yale U.Press. 1938).

behaviour of legal or natural persons. Ideologically and politically, regulation is often contested and is viewed from different perspectives. Thinkers on the right see regulatory intervention as a restriction on their liberties; the classical left views it as serving the interest of the bourgeois class; and for a progressive democrats, it is an efficient tool to iron out inequalities in a society and address other myriad social risks, e.g. environment, health and financial sector and so on.

However, traditionally the controversy about intervention is narrowly pitched between two schools of thought regarding whether regulation is necessary at all. The prominent economic theories are Adam Smith's *laissez-faire* and John Maynard Keynes' Keynesianism. Both of these theories deal with market failure in their own distinctive way. Both argue to promote stability, but it is impossible for either to achieve that because market failures – small or large – are inherent to markets.

Smith as such did not use the term *laissez-faire*; however the premise of his theory is that free trade between nations is beneficial for development.¹⁰¹ Notably, Smith expressed his idea as 'free trade', removing barriers to trade rather than a 'free market'.¹⁰² His idea was in response to mercantilist theory.¹⁰³ However, his idea has been applied to the 'free market' ever since.¹⁰⁴ Some would argue that Smith never intended his theory to be applied to economic theory, and doing has corrupted his idea.¹⁰⁵ Smith's theory is that markets will correct themselves with the intervention of the invisible hand.¹⁰⁶ He believed that the free market is an efficient market and that regulation will corrupt it.¹⁰⁷ However, it is strongly believed that his theory of *laissez-faire* proved to be inadequate in the Great Depression of the 1930s.¹⁰⁸

The opponents of intervention – the *laissez-faire* school – believe that "*the province of government should be restricted... to the protection of person and property against force or fraud*".¹⁰⁹ Broadly it means that the laws of the land in a particular legal tradition (e.g. common law or civil law and so on) are sufficient, and that there is no necessity for them to be supplemented by further regulation, i.e. government intervention in a private domain of the citizens or society. Smith makes the strongest

¹⁰¹ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations; The Wealth of Nations* (London, 1904); O Mutanga, *The 21st Century and its Challenges: Reconsidering the Keynesian State* 7(1) *World Journal of Entrepreneurship, Management and Sustainable Development* 39 (2011).

¹⁰² D Ben-David, MB Loewy, *Free-Trade, Growth, and Convergence* 3 *Journal of Economic Growth* 143 (1998).

¹⁰³ H Miller, DB Yoffie, *Between Free-trade and Protectionism: Strategic Trade Policy and a Theory of Corporate Trade Demands* 43(2) *International Organisation* 239 (1989).

¹⁰⁴ MA Zupan, *The Virtues of Free Market* 31(2) *Cato Journal* 171 (2011).

¹⁰⁵ WJ Samuels, SG Medema, *Freeing Smith from the "Free Market": On the Misperception of Adam Smith on the Economic Role of Government* 37 (2) *History of Political Economy* 219 (2005).

¹⁰⁶ A Smith (n 101); See also, P Oslington, *God and the Market: Adam Smith's Invisible Hand* 108 *Journal of Business Ethics* 429, 430 (2012); PT Lesson, CJ Coyne, PJ Boettke, *Does the Market Self-correct? Asymmetrical Adjustment and the Structure of Economic Error* 18 (1) *Review of Political Economy* 79 (2006); A Harel, G Harpaz and JC Francis, *Analysis of Efficient Markets* 36 (2) *Review of Quantitative Finance and Accounting* 287, 295 (2011).

¹⁰⁷ J Viner, *Adam Smith and Laissez-faire* 35 (2) *Journal of Political Economy* 198,199 (1927).

¹⁰⁸ MN Rothbard, *America's Great Depression* (Alabama, 2000).

¹⁰⁹ JS Mill, *Principles of Political Economy*, 525 (1848).

defence of this argument in the context of economics. He is an ardent opponent of government intervention (i.e. regulation) in the market; rather he advocates a free market that will correct itself.

On the other hand, the advocates of intervention believe that the government should intervene “*wherever its intervention would be useful*”.¹¹⁰ To make his case, John Stuart Mill opined in his discussion of “*sale of poisons*” that it was “*a proper office of public authority to guard against accidents*”.¹¹¹ He argued that, “[*if poisons were never bought or used for any purpose except the commission of murder, it would be right to prohibit their manufacture and sale*”.¹¹² He acknowledged that products might be complex, as in the case of poison. He argued that poisons may “*be wanted not only for innocent but for useful purposes and restrictions cannot be imposed in the one case without operating in the other*”.¹¹³ Therefore, in Mills view, precautionary measures such as labelling “*the drug with some word expressive of its dangerous character, may be enforced without violation of liberty: the buyer cannot wish not to know that the thing he possesses has poisonous qualities*”.¹¹⁴ A number of poisons such as tobacco products are still legal and their regulation remains contested. Similarly complex financial products like credit cards and investment instruments have a useful purpose but can be toxic if used recklessly. This regulatory approach has long been the tradition of the regulatory regimes in the UK and the US.

John Keynes put forward a robust argument in favour of regulatory intervention. His thesis is that markets do fail and in such circumstances regulatory intervention is inevitable to correct them.¹¹⁵ The history of regulation tells us that this debate about regulatory intervention has been won in favour of intervention. Most of the discourse is about the type and scope of the regulation. The failure of *laissez-faire* during the Great Depression in the 1930s revived Mill’s idea of state intervention in the form of Keynesianism.¹¹⁶ At the end of the Second World War, two ideas – Marxism and Keynesianism – emerged as alternatives to the *laissez-faire*.¹¹⁷ They emerged because capitalism and *laissez-faire* were both failing.¹¹⁸ America followed Keynesianism and witnessed a long period of stability.¹¹⁹

¹¹⁰ *Ibid.*

¹¹¹ JS Mill, *On Liberty*, 171-73 (UK, 1859).

¹¹² *Ibid.*

¹¹³ *Ibid.*

¹¹⁴ *Ibid.*

¹¹⁵ JM Keynes (n 47).

¹¹⁶ G Atkinson, T Oleson Jr, *Commons and Keynes: Their Assault on Laissez-faire* 32 (4) *Journal of Economic Issues* 1019, 1022 (1998).

¹¹⁷ P Kenway, *Marx, Keynes and the Possibility of Crisis* 4 *Cambridge Journal of Economics* 23 (1980).

¹¹⁸ D Dillard, *Keynes and Marx: A Central Appraisal* 6(3) *Journal of Post-Keynesian Economics*, 421 (1984); See also, J Crotty, *The Realism of Assumptions Does Matter: Why Keynes-Minsky Theory Must Replace Efficient Market Theory as the Guide to Financial Regulation Policy* in MH Wolfson and GA Epstein, *The Handbook of the Political Economy of Financial Crisis* (Oxford, 2012).

¹¹⁹ D Felix, *Keynesian Consequences* 41 (6) *Society* 58, 62 (2004).

Keynesianism expressed a view that *laissez-faire* on its own is unable to create a high level of employment and consequent economic stability¹²⁰ and that the depressions were avoidable¹²¹ with expansive policy.¹²² Keynesianism expressed that state regulatory intervention would materialise in high investment and consumption and hence high employment. Recently, during the 2008 financial crisis, a financial system and its banks that were viewed as ‘too big to fail’ were saved by Keynesian intervention across the world.¹²³

H. Conclusion: Market Failure, a Symptom of Subversion of Justice

Market failure is a symptom of the failure of common law, not in itself a cause for the emergence of regulation, as thought by economists. The concept of market failure, as generally understood, cannot be put forward as a rationale for regulation; rather it is used to set a threshold of subversion of justice beyond which adoption of regulation becomes necessary. It indicates how significant subversion of justice is in given circumstances. The concept of market failure is merely a cost-benefit analysis tool, used in the understanding of ‘risk’ and the cost of a particular risk. It allows us to measure whether a particular risk is bearable or whether the cost of regulation outweighs the benefits. Economic reasoning in the process of the development of regulations takes place once significant subversion of justice has been identified – a point where regulation in terms of economic benefit is legitimate.

Regulation is a legal concept and has an incidental relationship with market failures. It is about property rights and rights in general; inherently, the discussion of rights is a matter for law and politics, not economics. Property as an economic unit is primarily a legal concept. Furthermore, where necessary (in inefficient situation) regulation also criminalises actions and inactions of persons in orders to improve efficiency and achieve social justice.

¹²⁰ T Naggar, *Adam Smith’s Laissez-faire* 21 (2) *The American Economist* 35, 38 (1977).

¹²¹ D Fand, *Monetary Theories, Stabilization Policy, and Recent Inflation* 1(3) *Journal of Money, Credit and Banking* 556, 557 (1969).

¹²² D Felix (n 119), 58, 61.

¹²³ S Suarez, R Kolodny, *Paving the Road to “Too Big to Fail”*: *Business Interests and the Politics of Financial Deregulation in the United States* 39 *Politics and Society* 74 (2011); M Kitson, R Martin, P Tyler, *The Geographies of Austerity* 4 *Cambridge Journal of Region, Economy and Society* 289, 299 (2011).