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## Regulation and institutional framework

**JEL code:** P16

**Keywords:** economic policy, regulation, economic regulation, social regulation

**Summary.** While developing the state regulatory framework, economic and social values, considered as factors motivating particular interest groups that can be for and against the regulation, become particularly important. The challenge is to determine which of those values should be prioritised. Although we can list a number of factors that determine the significance of specific values, the starting point for the exercise should be the institutional framework.

### Introduction

Nowadays, we can observe a growing activity of the state in regulating economic processes in goods, services and capital markets. It can be seen in particular in electricity, gas, telecom, postal and railway transport markets which until recently have operated as monopolies. Although the majority of Polish monopolies came to an end with Poland's accession to the EU, their adjustment to market conditions is still in progress (Budziewicz-Guźlecka, 2011, p. 103). It should be emphasised that the economic role of the state, including its regulatory role, has been debated by economists for a number of years. The goal of the paper is to provide an in-depth and critical analysis of the theory of regulation and reference to the institutional context. The paper attempts to answer a question about factors determining the active role of the 'regulatory state'. Factors that play a major role in state regulatory activity include economic and social values. Those values should be considered as arguments put forward by various interest groups for or against regulation. Yet another goal of the article is to indicate values that can be described as strategic, and thus effectively influencing the regulation applied. Moreover,

the paper presents links between regulation, economic and social values and the institutional framework.

## 1. Regulation in the theory of economy

The specialist literature describes regulation as an activity of the state designed to convince households and companies to make specific decisions. In the theory of economy, we may distinguish two fundamental approaches to the regulatory function of the state. The first one is related to the normative theory of regulation, whereas the second to the positive theory of regulation represented by promoters of the economic theory of regulation (G.J. Stigler, S. Peltzman, G.S. Becker) and the theory of interest group regulation. The latter is linked to representatives of the new institutional economics, in particular the new political economics, such as: G. Tullock, J.M. Buchanan, A.O. Krueger and M. Olson (Szapiel, 2013).

It should be emphasised that positive regulation concepts assume that the regulation is a good, and its influence and tools develop depending on demand for regulation from interest groups and supply of regulation by interested political actors. While trying to respond to the question about the balance on the market subjected to regulation, the positive regulation theory provides various solutions. According to one of them, due to relatively low cost of organising collective activities and reducing the *free riding* issue, the regulation is intercepted by groups of narrow interests (Borkowska, 2013).

According to Peltzman model, the regulation is taken over by sector-related groups of interests, while taking into consideration the possibility of balance. Despite such conditions, it is pointed that benefits of the regulation are derived by consumers (Peltzman, 2004).

According the positive regulation theory, the third solution in the context of the regulation, as formulated by G. Becker, suggests that in relation to the symmetry of interest groups competing for benefits, the regulation leads to a sub-optimised solution, i.e. *the second best*. It means that the regulation works towards the public interest, since it enables to reduce the dead rent (Borkowska, 2013).

The versatile meaning of the regulation based on positive concepts results in more attention given to normative concepts that examine which regulation is the most effective assuming that an effective regulation exists and is desired.

It should be emphasised that the starting point for normative regulation concepts is the thesis that the market mechanism is prone to failure in two ways:

- market fails in reaching effective allocation of social resources,
- market fails as regards the implementation of social goals other than those attributable to economic efficiency.

This approach enables distinguishing the economic regulation and the social regulation (Borkowska, 2013).

On the one hand, the economic regulation is defined as regulating the market structure and the behaviour of entities operating in those markets. The regulation of the market structure involves verification of entries and exits from the market and determination and enforcement of rules for the provision of public services. The regulation of behaviour of entities operating in those markets concentrates on controlling of prices, determining and enforcing rules pertaining to advertising and minimum quality standards. It should be highlighted that the economic regulation is treated as the activity of the state on natural monopoly markets and other markets with a structure limiting competition or destructive competition. While referring to those markets, the literature uses a term of ‘sectoral regulation’, which indicates that due to a specific imperfection of the market, a specialist institution is established to regulate a given market (sector) (Szpringer, 2010, p. 57). An example of the economic regulation is the regulatory activity on the telecom market, which in the EU is designed to establish the single competitive market of telecom services (Czaplewski, 2015, p. 66).

On the other hand, the social regulation encompasses the activity of the state aimed at ensuring the security of products purchased by customers, work safety, care of the natural environment, as well as to reduce consumption of goods that are detrimental to health, broaden consumption of socially desired goods, and protection against shortages and unemployment. While considering the scope of influence, the social regulation can be defined as the activity of the state designed to ensure socially desired uses of goods, protecting people against the risk related to the operation in the market economy (Levi-Faur, 2011; Borkowska, 2013). The focus is also put on counteracting social exclusion and stratification (Kuczera, 2012, p. 768–769).

While performing a critical analysis of literature on normative regulation concepts, described as the public interest theory of regulation, we should emphasise its multifaceted nature.

Firstly, doubt has been raised regarding market errors defined by the theory and related to imperfectly competitive markets, asymmetry of information and negative selection, external effects and public goods. Secondly, the theory of regulation points in the public interest to the methodological lack of cohesion related to the fact that the diagnosis of market errors is based on assumptions related to the methodological individualism (rational approach, interests of people maximising usability) and those assumptions are adopted for considerations regarding the society. This leads to treating of the society as a subject which, similarly to an individual, makes cohesive choices, has their own hierarchy of values and maximises clearly defined function of wealth. Thirdly, the theory of regulation in the public interest is accused of incompleteness, since the theory does not indicate the way public interest is determined and transposed onto legislation to maximise the social wealth (Borkowska, 2013).

## 2. Dependence between economic and social regulations

According to E. Windholz and G. Hodge (2012) the social regulation can be considered in the following contexts:

- activity of the state aimed at correcting market errors,
- activity of the state aimed at the implementation of values desired by the society.

In the first instance, the social regulation is treated as an element of economic regulation while considering that market errors related to external effects, public goods and asymmetry of information are corrected to the extent that does not interfere with the implementation of economic values. The relationship between the economic and social regulation, while considering values implemented, is presented in figure 1.



Figure 1. Social regulation as element of economic regulation

Source: Windholz, Hodge (2012), p. 224 after: Borkowska (2013), p. 204.

It is necessary to determine the hierarchy of values:

1. Superior values include:
  - economic efficiency,
  - competitiveness,
  - innovation.
2. Subordinate values include:
  - justice,
  - equality,
  - social solidarity,
  - clean air,
  - healthy society,
  - educated society.

According to the second approach by E. Windholz and G. Hodge, which assumes that regulation can be used to implement goals desired by the society, the relationship between the economic and social regulation can be as presented in figure 2.

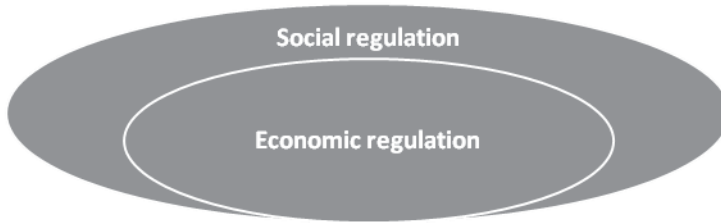


Figure 2. Economic regulation as element of social regulation

Source: Windholz, Hodge (2012), p. 224 after: Borkowska (2013), p. 204.

It should be highlighted that the hierarchy of values change. Supreme values include: justice, equality, social solidarity etc., where economic values, such as efficiency, competitiveness and innovation, become subordinate ones which are implemented to the extent that does not interfere with goals of the social regulation.

From the point of view of the hierarchy of values, while justifying the concept of relations between the economic and social regulation, it is highlighted that the regulation does not take place in an economic and social void. Attention should be drawn to the relationship between the economic and social regulation. In the case of the social regulation, the generation of high cost is important, since it does not take into consideration economic values, is not stable and may encounter a breakdown.

It should be indicated that the situation may also repeat in the context of the economic regulation when one disregards values and norms of a given society.

### 3. Regulation in the context of the institutional framework

An element having a significant influence on both economic and social regulation is the institutional framework, including legal norms, social norms and their enforcement. It should be emphasised that, on the one hand, the framework creates barriers, and on the other, highlight the activity of people in economic and political spheres. While referring to this issue, we should also point to a diverse institutional structure of the state, a structure which includes barriers and stimulating factors having their impact on redistribution and productivity. Moreover, depending on quality and structure of institutions, the activity of public persons and interest groups may vary which results in a different failure level of the state as a market regulator.

While referring to the influence of the institutional framework, we should highlight a particular significance of institutions that influence the process of regulation and its effects. An efficient regulation process depends on the capacity of a given institution. Among many public institutions, crucial factors include (Borkowska 2013):

- election rules,
- form of the executive branch,

- regulation of relations between the legislative branch and the executive branch,
- efficiency of the judicial branch in countervailing the legislative branch and the executive branch,
- political independence of the regulatory agency,
- rules for appointment to positions in public administration, and
- behavioural norms determining political culture.

They determine the political system of the state. Moreover, based on the analysis of the relationship between those elements, we may conclude that a specific configuration of public institutions supports different regulatory solutions. In Poland, a basic constituent part of the institutional framework that defines freedom, rules and principles shared by a society is the constitution. The constitutional order does not define the hierarchy of values, instead it guarantees not only rights and freedoms of people, but also shapes the policy in the field of financial balance of the state, principles of sustainable development and social market economy.

Considering the above, while referring to the state regulation of markets in Poland, we may assume that the relationship between the economic regulation and social regulation is as presented in figure 3.

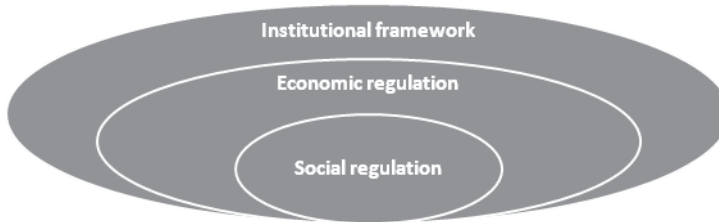


Figure 3. Institutional framework and social and economic regulation

Source: Windholz, Hodge (2012), p. 224 after: Borkowska (2013), p. 207.

The relationship between the economic and social regulation shows a common part which results from the constitutional order that recognises certain economic and social values as equal. It is also crucial to apply the same rules both in economic and social spheres, for instance the principle of non-discrimination, which for citizens is defined as equality against the law, and for businesses as equal access to the market, and can be defined as a guarantee of equality in the social sphere in terms of social inclusion. Summarising, it seems that it is hard to explain the process of regulation in general without taking into consideration the institutional framework, and more specifically the issue of different values used as arguments supporting specific regulatory solutions.

## Conclusions

An indispensable element of contemporary economies is a broad and growing range of state regulation. As it has been shown, while shaping the state regulation economic and social values play an important role (Kotylak, 2013). They are treated as factors motivating specific groups of interest to support or oppose a specific regulation. Indicating which values should be prioritised remains a challenge. We may point to a number of factors determining the importance of specific values. However, the starting point is the institutional framework as a tool determining the direction of the state policy as regards regulation and the implementation of that regulation.

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**REGULACJA A RAMY INSTYTUCJONALNE**

**Słowa kluczowe:** polityka gospodarcza, regulacja, regulacja ekonomiczna, regulacja społeczna

**Streszczenie.** W kształtowaniu państwowej regulacji istotnego znaczenia nabierają zarówno wartości ekonomiczne, jak i społeczne, traktowane jako motywy działań poszczególnych grup interesów na rzecz i przeciw regulacji. Problemem jest wskazanie, które z wartości należy uznać za priorytetowe. Można tu wskazać na wiele czynników determinujących rangę poszczególnych wartości, jednak punktem wyjścia są ramy instytucjonalne.

*Tłumaczenie Anna Drab-Kurowska*

**Cytowanie**

Drab-Kurowska, A. (2017). Regulation and institutional framework, *Ekonomiczne Problemy Usług, 1* (126/1), 81–88. DOI: 10.18276/epu.2017.126/1-09.