

**The Challenge of Incomplete Law
And How Different Legal Systems Respond to It¹**

Katharina Pistor
Columbia Law School

and

Chenggang Xu
Department of Economics, London School of Economics

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1. Introduction

Two hundred years ago France set out to codify its law in the Napoleonic codes. These codes covered what were then perceived to be the core areas of any legal system, whether it belonged to the common or civil law family: civil law, criminal law, commercial law, civil procedure and criminal procedure law.² Courts were the primary institutions charged with enforcing these laws. Over the last one hundred years, however, in volume and arguably importance, these classic areas of the law have been outgrown by administrative or regulatory law, which encompasses everything from financial market over safety and food, to telecom regulation. In addition, there have been major changes in the institutions that administer and enforce this body of law. Law enforcement powers have been delegated to administrative bodies. Alternatively, new institutions, often referred to as “independent” regulators, were established to enforce this growing body of law. This development is often characterized as the rise of the ‘regulatory state’.³

This paper interprets the rise of the regulatory state as a response to the deterrence failure resulting from incomplete law. In previous work we developed the incomplete law theory to explain the increasing importance of regulators in the most developed economies.⁴ In that work as well as in the current paper we focus on countries that use formal law as a major governance device, or that have made a firm commitment to the rule of law. Moreover, we limit the analysis to a particular sub-set of regulation: the management of risk when actions can be economically beneficial, yet carry the danger of

² (Glendon, Gordon, and Osakwe, 1994).

³ (Glaeser and Shleifer, 2003; Landis, 1938; Moran, 2002).

⁴ (Pistor and Xu, 2003; Xu and Pistor, 2003).

causing substantial harm. Other areas of regulatory policies, such as regulation aimed at redistribution or other social goals, are excluded from our analysis.⁵

The incomplete law theory suggests that law is inherently incomplete and therefore cannot offer solutions for problems which are not precisely specified in the law. For the purpose of this paper we define law as a rule or standard that is established by a body with lawmaking authority rather than the legal system in a broader sense. In other words, we are referring to “*loi*” or “*Gesetz*” rather than “*droit*” or “*Recht*”. The relevant lawmakers may choose to make law relatively more or less complete. Still, even if they were inclined to write a “complete” law, they would be bound to fail given law’s inherent incompleteness at least when confronted with a changing environment. Incompleteness of law thus does not imply a negative connotation, but a simple fact.

An important implication of the insight that law is inherently incomplete is that law cannot effectively deter harmful actions at a level that would be socially optimal. We define the social optimum as a hypothetical world in which those actions (but only those) would effectively be deterred, the social harm of which exceeds its social and private benefits. When socioeconomic development and/or technological change is rapid, the incomplete law issue is more pronounced as legal development is not able to keep pace with these changes. This undermines the ability of any legal systems to effectively deter harmful actions, causing harm not only to individuals, but to public goods, including public health or the functioning of financial systems. The countries we analyze in this paper have all responded to the problem of deterrence failure caused by incomplete law by creating and allocating regulatory functions (for a definition see below) to state agents

⁵ For a detailed account of policy concerns that may justify regulatory intervention, see (Stewart, 1975) at pp. 1691.

other than courts. They have done so irrespective of whether they belonged to the civil or the common law family. These legal systems did not only amend existing and enact new law. Nor did they limit their reforms to changes in procedural law, for example by increasing the standard of care, by reallocating the burden of proof, or by extending standing in court. They created new agents and vested them with combined lawmaking and law enforcement powers. As a short hand, we refer to these agencies as regulators.⁶ Regulators have not replaced courts. In fact, as will be further discussed below, courts are frequently used as agents of governance over regulators. However, regulators have filled a gap a legal regime that relies entirely on reactive law enforcement by courts cannot fill. In this sense, courts and regulators are not substitutes, but complement each other.

The major difference between regulators and legislatures as lawmakers is that while the lawmaking powers of regulators is typically narrower than that of legislatures, regulators are less burdened by procedural requirements and can therefore more flexibly respond to changes. The major difference between regulators and courts as law enforcers is that courts have to wait for others to bring action before being able to enforce the law. By contrast, regulators are typically empowered to initiate enforcement procedures. Obviously, this characterization captures only basic functions of legal institutions and ignores variations across legal systems. However, we submit that these functions are crucial for understanding why regulatory functions have become necessary irrespective of a particular political constellation, which is often blamed for this phenomenon.⁷

⁶ As noted above, many specific forms of regulation are not covered by this study. Moreover, as will be further discussed below, regulators are not always separate institutions. In many countries regulatory functions are carried out by traditional state administrations, such as the ministry of health, agriculture, finance, etc.

⁷ This is most explicit in the US, where the rise of the regulatory state has been closely associated with the progressive administration of FDR Roosevelt and his “New Deal”. For a historical account, see, for example (Sunstein, 1987).

All leading industrializing countries have allocated some lawmaking and law enforcement powers to regulators in some areas in response to the challenges posed by the socioeconomic and technological change brought about by the process of industrialization. While this has mitigated the enforcement problems posed by incomplete law, it has created problems of its own, and most importantly: how to control regulators. Governance structures had to be created that would not fall prey to the same incomplete law problems they were created to overcome. If law is inherently incomplete, as we suggest, then it is obviously impossible to control agency decision making by writing a complete law that would clearly set out their jurisdiction. Thus, other governance devices have to be developed to address the problem of governing regulators. The question “*quis custodiet ipsos custodes?*” is an ever-recurring governance problem. In this paper we point out that legal systems have toyed with different approaches to resolve the governance problems. Simply put, some use oversight and monitoring within a hierarchical system, others rely more on horizontal mechanisms, including inter-agency monitoring as well as litigation by affected citizens. Our major point here is that legal family alone provides very limited explanation power on evolution and governance of regulatory regimes. Instead, how lawmaking and law enforcement power is allocated may explain the evolution and governance of regulation better. Together with legal families, historical legacies, path dependency as well as constitutional constraints affect the choices for legal systems and may thus at times impinge their ability to optimize governance. By the same token, this also implies that governance structures that may work well in one particular legal system may create tensions when super-imposed on another. It should be the task of bijuridical analysis, and more broadly, of comparative

law, to analyze the “fitness” or alternative governance mechanisms in light of these constraints.

The paper is organized as follows. Section 2 summarizes our incomplete law theory. Section 3 discusses the initial allocation of lawmaking and law enforcement powers in traditional tort law. Section 4 describes how different countries have reallocated lawmaking and law enforcement powers to regulators. Section 5 presents a theoretical discussion of alternative governance mechanisms to control regulators. Section 6 explores particular regime choices made by different jurisdictions and their compatibility with existing constraints. Section 7 concludes.

2. Incomplete Law and Deterrence Failure

The incomplete law theory we develop elsewhere⁸ was inspired by the incomplete contract theory developed in the economics literature.⁹ We define incomplete law negatively by contrasting it with an ideal type complete law. We regard a law as complete, if all relevant applications of the law are unambiguously stipulated in the law and the law can therefore be enforced literally provided that evidence is established. This requires that the law is self-explanatory, i.e. that every addressee agrees to the meaning of the law, and by implication that there is no need for a third party to interpret the law. Otherwise, a law is incomplete, that is, some of the relevant issues are not stipulated in the law or they remain ambiguous. An incomplete law cannot be enforced literally even when evidence is established.

⁸ See Pistor and Xu *supra* note 4.

Our basic premise is that law is intrinsically incomplete.¹⁰ This is the case, because law is generally designed to last long and to apply to a large group of addressees and cases. These attributes contribute to the stability of the legal system and ensure equality before the law. At the same time, however, they invariably increase the incompleteness of law. Just as contractual parties cannot foresee all future contingencies, lawmakers (including legislatures and judges) have limited capacity to proscribe all possible issues that may arise under the law. To avoid that in each case where the law does not fit exactly a case will be dismissed or an accused acquitted, the power as to who may determine, if and how a law shall be applied to a particular case must be allocated, as otherwise the law cannot be enforced. We call this power to apply existing law to new cases and adapt it in the process of doing so the “residual” lawmaking power. The power to make new law from scratch, by contrast, is the “original” lawmaking power.

Note that failure to specify actions the law seeks to deter *ex ante* is different from establishing evidence *ex post*. In many cases, violators of the law will escape liability, because it is either impossible or too costly to establish evidence about who took the relevant action or the causal relation between the action and the harmful outcome – an issue that is well explored in the law enforcement literature.¹¹ By contrast, incompleteness of law implies that it is impossible for the lawmaker to specify all relevant actions that may result in the harm the law seeks to prevent. This problem may be compounded by evidence problems, but is logically separate. When considering

⁹ (Hart, 1995). For a differentiation of the incomplete law theory from other theories, in particular the indeterminacy of the law, see (Pistor and Xu, 2003) *supra* note 4.

¹⁰ On the surface the notion of incomplete law may sound trivial or not completely new to the literature (e.g. H.L.A. Hart’s notion of the indeterminacy of law shares some features of incomplete law (Hart, 1961)). The major contribution of this theory, as we see it, however, is to offer a rigorous framework for analyzing institutional design and the relation between legal design and institutional design.

whether an action should be litigated or prosecuted, lawyers typically consider the hypothetical case that evidence can be established to determine whether or not the relevant action can be challenged on legal grounds. If this is uncertain, the deterrence effect of the law is undermined. For most cases this is tolerable as the expected level of harm is relatively low. When the expected level of harm is sufficiently high, however, in particular when the number of victims is expected to be high and/or the action is likely to result in additional negative externalities, the inability of the law to effectively deter may cause substantial social welfare loss. Examples include the failure of the law to deter the use of harmful substances that may seriously affect health or life of many victims, or stock fraud schemes that may not only harm investors buying shares of a particular company, but undermine confidence in financial markets, which may ultimately result in market collapse with further consequences for the economy.¹²

If it was possible to specify ex ante the type of actions that may cause the harm the law seeks to prevent, law could be designed to deter harm caused by these type of actions and determine the appropriate level of liability or sanction to deter these actions. Thus, if the lawmaker could specify all harmful substances ex ante and determine in what cases the social harm outweighs any private or social benefits, courts could effectively enforce the law and most harmful actions would be deterred. Similarly, if lawmakers could anticipate all side effects of pharmaceuticals, they could write a law to ensure that only drugs were produced for which the side effects were manageable.¹³ Finally, if it was possible to determine ex ante the many ways in which investors might be cheated by

¹¹ (Becker, 1968; Stigler, 1970). For a survey of this literature, see (Polinsky and Shavell, 2000).

¹² (Romer, 1990).

¹³ Alternatively, the lawmaker may require mandatory insurance for the ‘most dangerous’ drugs, substances, etc.

share issuers, the law could be written to deter most of these actions – and so forth.

Unfortunately, in many cases this is too costly, or simply impossible, because the possibilities brought about by scientific and technological change as well as the ingenuity of individuals in pursuit of maximizing their interests are impossible to foresee.

One may hold against this argument that it might still be possible to state that liability will be incurred whenever the social harm outweighs private plus social benefits. However, at best such a statement would be too vague to be of any useful guide to actors or courts, and at worst it may over-deter and thereby undermine social, scientific, and technological progress.

Traditionally, the power to determine the scope of a law when applying it to a particular case has been vested with the courts, both in civil and in common law jurisdictions. Increasingly, however, this power has been shifted to, or is shared with, regulators. A number of authors have already suggested that, under certain conditions, regulators may be better placed than courts to enforce the law at socially optimal levels. Some see the major reason for the superiority of regulators in their ability to *make* rules ex ante where courts are limited to ex post lawmaking.¹⁴ Others have stressed that under conditions that resemble complex and long term contracts institutions that are capable of continuously monitoring or managing these relations are required.¹⁵ We build on these contributions and suggest that a further important institutional feature of regulators is that they have the power to initiate enforcement procedures, whereas courts remain passive until another party (the victim or a state agent) has taken the initiative. We therefore call courts “reactive”, and regulators “proactive” law enforcers. The fact that courts are

¹⁴ (Shavell, 1984).

¹⁵ (Goldberg, 1976; Priest, 1993).

reactive law enforcers enhances their independence and impartiality. By designing rules and initiating enforcement procedures, regulators take sides. Moreover, the combination of lawmaking and law enforcement powers in the hands of a single state agent gives regulators substantial discretionary powers. This raises new and important governance challenges.¹⁶

In our earlier work we show that when law is highly incomplete, reactive law enforcement by courts cannot ensure socially optimal levels of law enforcement. In particular, reactive law enforcement alone may result in deterrence failure and cause major harm to social goods, such as financial systems or public health. Allocating lawmaking and law enforcement powers to agents that can initiate enforcement proceedings and change rules flexibly to accommodate technological or socioeconomic development, can enhance the socially optimal level of law enforcement and thereby improve social welfare. Put differently, we argue that the invention of regulatory functions was at least in part determined by the inability of traditional law enforcement institutions to effectively cope with the challenges posed by socioeconomic and technological change. Other theories hold that regulators were created in response to interest group pressures and serve primarily their needs.¹⁷ Moreover, it has been suggested that legislatures often favor delegating lawmaking functions to regulatory agents in order

¹⁶ Governance of courts and judges is a difficult task as well. The debate about judicial independence and impartiality has long moved beyond the simple notion that independent judges are bound by the law and nothing but the law and will act in accordance with these constraints. On the debate of judicial independence (Landes and Posner, 1975; Posner, 1993); critically, however (Boudreaux and Pritchard, 1994). Further on the political economy of judicial independence (Ramseyer, 1994) and (Stephenson, 2003). While we recognize the importance of the question as to how judges are held accountable to the law, in the current research we focus on regulatory accountability not the least because of the extensive powers regulators have as a result of vesting combined lawmaking, adjudication and law enforcement functions in their hands.

¹⁷ See (Stigler, 1971) and (Posner, 1974) for these earlier theories of regulation.

to avoid political responsibility.¹⁸ More recently, Majone has suggested that regulators are a device used by legislatures to achieve credible policy commitments.¹⁹ Our theory differs from the above in that we suggest that the fundamental cause for regulation is not political, but is an inherent weakness of law when faced with conditions that render it incomplete and thus undermine its power to effectively deter harmful actions. We do not believe that politics are unimportant. In fact, political factors are, as we show in this paper, important determinants of regulatory regime choices. However, for the rise of regulators as proactive law enforcement agents, politics in our view plays role only to explain the differences among regulatory states, not the rise of regulatory states.

3. Initial Allocation of Lawmaking and Law Enforcement Powers in Common law and Civil Law Countries

Comparative scholars divide the law into two major legal systems – the civil law system and the common law system. Using our language of incomplete law and lawmaking power allocation, we can summarize the two systems as follows. A widely held notion in the literature is that the two systems differ fundamentally in the initial allocation of lawmaking powers.²⁰ Civil law systems allocate original lawmaking powers to legislatures, and vest courts only with limited [CG: in the incomplete contract convention, if any party has all the residual control, that party will be the owner.

¹⁸ See (Fiorina, 1986). See also (Salzberger, 1993) for a similar argument for delegating lawmaking powers to courts.

¹⁹ This argument is in fact closely related to Landes and Posner's (supra note 16) argument about judicial independence. They argue that in order to ensure interest groups that bargains will be upheld even after they hand over power to the opposition, rulers will favor an independent judiciary.

²⁰ (David and Brierly, 1985; Zweigert and Kötz, 1998).

Similarly here what we mean is that the court has some lawmaking power but not all] residual lawmaking powers (the scope of which varies across different areas of the law). In principle, courts may interpret the law, and may occasionally fill some gaps, but they may not make new law. In contrast, common law countries vest courts with important original as well as residual lawmaking powers.

This conventional wisdom is a gross over-simplification of how different legal systems function in the real world.²¹ Not only is the boundary between interpreting the law, filling the gaps, and making new law often difficult to draw, but many provisions in, say the French or German civil codes, are so general that they implicitly allocate more extensive residual lawmaking powers to courts than the conventional wisdom suggests.

Rather than starting with the conventional wisdom, we determine the initial allocation of original lawmaking and law enforcement powers for specific areas of the law in the countries included in our study. They include England, France, and Germany, i.e. the “mother countries” of the major legal systems, the common law, the French and the German civil law systems. In our discussion of regulatory structures we also include the US and Canada. Both countries belong to the common law family, but as we will show below, their institutional designs differ not only significantly from each other, but – especially in the case of the US - in important ways also from England.

We start our analysis with simple tort law and ask how different legal systems have initially allocated the residual lawmaking and law enforcement powers in this area of the law. We select tort law, because this is the area of the law which traditionally has been responsible for allocating entitlements and risks between private parties that have no

²¹ (Mattei, 2000).

previous contractual relationship.²² Much of the regulatory law we are interested in has complemented and sometimes superceded tort law.

Tort law is by nature highly incomplete. The type of actions that may result in harm, the level of damages that may be caused, and the assets that require protection by law are difficult to anticipate precisely by the original lawmaker. At the time the French Code Civil was enacted in 1804, railways, cars or airplanes had not been invented, nor could anybody have foreseen the massive changes technological progress brought to the production of goods, and the benefits, but also the harm that could result from these changes. In other words, the possibility of using DDT or Asbestos had not yet been explored, much less were the side effects from using these materials anticipated.

Given the incompleteness of tort law, major harm to society could result from under-enforcement of the law, unless legal systems found ways to properly allocate residual lawmaking and law enforcement powers. Suppose a legal system enumerates the type of actions known that causes harm at the time the law is enacted and stipulates that only those actions can give rise to damages. Suppose further that this system denies courts the power of residual lawmaking and confines them to law enforcement. Such a system would most likely suffer from substantial enforcement failure problems. Not only would it be easy to circumvent the law by using actions not defined therein, but future harmful actions that were not anticipated at the time the law was enacted could not result in liability. Obviously, the lawmaker could change the law, but this takes time and in the interim much harm can be done. A legal system that used a sweeping definition of tort liability, but denied courts the power to exclude actions that do not result in major harm from liability would be equally problematic. Such a system would over-deter as courts

²² (Coase, 1960).

would have to impose liability even when only little harm was done, or when the causal relation between actions and consequences was only remote.

As will become apparent in our analysis, each legal system has developed a different mix between allocating extensive lawmaking powers to the courts and vesting these powers primarily with the legislature. The results are sometimes counterintuitive, at least if one starts from the simplified premise that civil law is rigid and constraints judges in lawmaking, whereas common law vests them with extensive lawmaking powers. As it turns out, France has the most sweeping definition of what amounts to a tort action that may result in harm and leaves it to the judges to delineate actions that should not be covered by it. As a result, tort law in France is primarily case law. By contrast, England has only gradually rid itself of a rather rigid framework of different tort actions, which courts had developed over time. Moreover, courts have increasingly deferred decisions about extending tort liability to the legislature and exercised remarkable judicial constraint in this respect.

United Kingdom

In the UK, the classic common law country, courts exercise both original and residual lawmaking powers to this day, even though statutory law is much more prominent today than it was two hundred years ago. Tort law can be described as the sum of all classes of cases that have been recognized by the courts as causes for liability absent a contractual relation.²³ Historically, a special writ had to be filed for each case. Special writs, or procedural forms to present a case, existed for conversion, nuisance, defamation, negligence, or deceit. Prior to the judicial reforms of 1875, failure to properly classify a

case could result in dismissal of the case. Even though this formalist approach was then abandoned, common law courts have long continued to classify tort cases in accordance with the traditional typology.

This rather narrow procedural approach created by the English common law may result in under-enforcement and thus deterrence failure, as existing categories did not always cover new cases that arose with the process of industrialization and socioeconomic development.²⁴ However, courts could, and indeed did adapt existing tort principles to new cases. Courts have developed liability for negligent conduct as a separate cause of action during the course of the 19th century. In response to the growing number of cases of accidents that resulted from the use of machines or the railways, courts held that not only positive wrongful actions, but also failure to follow reasonable standards of precaution could give rise to liability. In doing so they could uphold the traditional doctrine of “no liability without fault” while taking account of a changing environment in which individual action could place many others at risk.²⁵

With the growing importance of the parliament as statutory lawmaker in the UK, courts have deferred what they considered to be substantive changes in the law to the legislature. In *Derry v. Peek*, a landmark case concerning the scope of liability of company directors for misrepresentation of information in a prospectus for the issuance of shares, the House of Lords explicitly noted that it may be desirable to hold directors to

²³ See (Zweigert and Kötz, 1984) pp. 342 and pp 417.

²⁴ For the inability of courts to respond effectively to the growing number of white collar crimes in late nineteenth century Britain, see (Robb, 1992). On the incompleteness of the case law that was created in response to these challenges, see Pistor and Xu (2003) supra note 4.

²⁵ Obviously, courts did not develop their response to these new challenges in isolation. They could rely on legal doctrine (as pointed out by Antonioli and Mattei in their comments to this chapter) as well as on a growing public debate on the effects of industrialization on morals, the social fabric and the legal system. See only (Banner, 1998) for an analysis of the cultural and political background against which financial market regulation developed in the United Kingdom and the United States.

a higher standards of care than required by classic fraud law, but that it would be for the legislature to take such actions.²⁶ In fact, the legislature intervened and enacted the Directors' Liability Act only a year after this decision came down, which in effect shifted the burden of proof that they acted properly to the directors.²⁷

Where the legislature did not intervene, courts only cautiously extended the scope of liability. Thus, courts upheld the principle that negligence would result in liability only, if the injuring person owed some duty to the injured person. In a decision rendered in 1893, Lord Esher held that "A man is entitled to be as negligent as he pleases towards the whole world if he owes no duty to them".²⁸ Still, for goods that were deemed particularly dangerous, including poison, explosives, and weapons, a special duty was not required. Furthermore, in 1932, the House of Lords decided that the producer of goods could be held liable vis-à-vis the final user, to whom he, in principle, did not owe a special duty, if it was impossible for the retailer or the final user to ensure that the good did not suffer any defects.²⁹ Nevertheless, strict liability, i.e. liability without negligence or intent, has been acknowledged by English common law courts only in exceptional cases.³⁰ In principle, courts have called for legislative intervention and an increasing number of special laws, including the Civil Aviation Act of 1949, the Nuclear Installations Act of 1965 and the Gas Act of 1965 establish strict liability for harm caused in the operation of these facilities. These acts, however, are highly incomplete in that each covers only a

²⁶ Derry v. Peak (1889, 14 A.C. 377) at p. []. See also our analysis of this case in (Pistor and Xu, 2003).

²⁷ REF

²⁸ Lord Esher in *LeLievre v. Gould*, [1893], 1 Q.B. 491, 497 as quoted in (Zweigert and Kötz, 1984) at 351.

²⁹ See *Donoghue v. Stevenson*, [1932] A.C. 562.

³⁰ Arguably, only a single case has been handed down that establishes strict liability, namely *Rylands v. Fletcher* [1868], LR. 3 H.L. 330, which involves a case where a an owner who built a water reservoir on his property was held liable for damages caused when the water flooded the coals mines on the adjacent

particular industry. Industries or services not covered by special legislation are still covered by the traditional common law of torts.

Interestingly, courts in the United States, albeit also a common law country, have been more aggressive in establishing strict liability at least in cases where a product or the operation of a facility is deemed inherently dangerous. In the US the legislature is increasingly called upon to intervene in order to *limit* rather than expand the liability of producers or operators.³¹ This example already suggests, that legal families may have only limited explanatory power for explaining the scope of lawmaking powers courts are willing to assume or the deference they grant to either legislatures or regulators.

France

In France, the original lawmaking powers of the courts were curtailed with the codification of core areas of the law at the beginning of the 19th century and, as will be further discussed below, with explicit constraints placed on the judiciary's ability to review executive or administrative acts. Nevertheless, courts have continued to play an important role in residual lawmaking. In fact, the civil code implicitly allocates substantial residual lawmaking powers to the courts by including a very broad general tort provision, which establishes that anybody who causes harm to another either intentionally or negligently, is obliged to compensate.³² Given the broad mandate in favor of liability established by the code, it is not surprising that courts had less trouble than

property, even though negligence could not be established. The major reason for granting liability was that the property had been used in a non-natural fashion [CHECK].

³¹ The most recent example is a bill aimed at limiting the liability of gun producers [CHECK].

³² The two leading provisions are Arts. 1382 and 1383 of the code. Art. 1382 reads, "Tout fait quelconque de l'homme, qui cause à autrui un dommage, oblige celui par la faute duquel il est arrivé, à le réparer. Art. 1383 reads, „Chacun est responsable du dommage qu'il a causé non seulement par son fait, mais encore par sa négligence ou par son imprudence“.

either English or German courts to recognize liability for immaterial damages (which German courts deny), or, in the case of wrongful deaths, to hold the injurer liable to large group of claimants, including not only the immediate dependants, but also siblings, foster parents, or fiancées, and in individual cases even the employer of the deceased.³³ The highly incomplete nature of the law has resulted in cases being referred to the French supreme court (cour de cassation) to address the question, whether even the creditor of the deceased should be allowed to claim compensation from someone who caused the debtor's death and was unable to obtain relief from his legal successors. Thus, it has been the task of the French courts [CG: did you mean the supreme court? If not, I am a bit confused. If yes, then there is a typo?] to constrain the scope of the sweeping liability established in the code, rather than to expand it gradually, as has been the case in England.

An important condition for liability under French law is fault in the form of either negligence or intent. Again, courts have not had much trouble in recognizing fault in a diverse set of cases, including for misuse of rights (*abus d'un droit*), which has given rise to liability in cases where contracts were dissolved in a manner that caused damages to the other party. As far as strict liability is concerned, the code itself explicitly requires negligence or intent and until the end of the 19th century it was virtually undisputed that liability required fault. In 1896, however, the *court the cassation* handed down a decision in which it presented a new interpretation of the tort provisions contained in the civil code. Several provisions of the code establish liability for harm caused by an animal or building in the possession of or under the guard of a person, who *qua guardianship* is

³³ (Zweigert and Kötz, 1984) at p. 359. For example, a soccer club could demand damages from the person who caused the death of a soccer player for the transfer sum they had to pay.

held liable for harm caused by these objects or things. The court extended the application of these provisions to other cases where things under guard (“que l’on a sous sa garde”) caused the damage and ruled that such circumstances gave rise to the presumption that the person was liable. A growing body of case law to this end was confirmed in 1930 by the famous “arrêt Jand’heur”, which established the general presumption that someone deemed guardian of a thing (i.e. in this case a car), could be held liable for any harm caused by it regardless of fault.³⁴ The court thereby established strict liability of the owner of a car for damages caused by it. France has also enacted a number of special laws that create strict liability for particular industries. Nevertheless, case law is the major source of tort law in France in the sense that it is the most important device for delimitating those actions that should not incur liability notwithstanding the broad definition of tort liability in the Code Civil.

Germany

The German civil code was enacted only in 1900 [CG: did you mean 1800?] and presents the culmination rather than the starting point of legal responses to the challenges of the 19th century. Some trends that proved important for the further development of tort related law originated prior to the adoption of the civil code. In particular, Prussia established strict liability for railway accidents by passing a special statute on this matter. Moreover, in 1871 the law on liability (*Haftpflichtgesetz*) was enacted, which establishes

³⁴ Ch. Réun. 13.2.1930, S. 1930. 1. 121.

strict liability for all damages to life or health that occur in relation to the operation of a train (*bei dem Betriebe*).³⁵

The German civil code (BGB) includes a handful of tort provisions. The general tort provision is less sweeping than its French counterpart.³⁶ Only damages caused to life, liberty, health or property can give rise to liability. There is a small window for expanding the scope of the law, as the code explicitly mentions “other rights” (*sonstige Rechte*). Much of the early case law was therefore devoted to establishing *what* other rights might be recognized as similar to those enumerated to give rise to liability.³⁷

Just as in France, the code itself establishes liability for intent as well as negligence. Yet, German courts have been more reluctant than French courts to develop the scope of liability further and impose strict liability by way of case law. Arguably, this avenue was already precluded by specific legislative interventions, such as the 1838 Prussian railway law, or the 1871 general liability law. In this case, the legislature had indicated its original lawmaking powers in this area and courts respected this. As a result, strict liability to this day is confined to areas where the legislature has enacted a special statute establishing strict liability. In most cases these statutes also include upper ceilings for the amount paid for a single accident.³⁸

³⁵ A revised version of the same law is still in force today. See *Das Haftpflichtgesetz* as (re-)announced on 4 January 1978, BGBl. I, 145) and last amended on 15 December 2003, BGBl. I, 2676) states that whoever negligently or intentionally damages someone’s life, liberty, or property will be liable for compensation. “Wer vorsätzlich oder fahrlässig das Leben, den Körper, die Gesundheit, die Freiheit, das Eigentum oder ein sonstiges Recht eines anderen widerrechtlich verletzt, ist dem anderen zum Ersatz des daraus entstehenden Schadens verpflichtet.“

³⁶ Section 823 of the Civil Code (last re-enacted 2 January 2002, BGBl. I, p. 52 with further amendments introduced on 15 December 2003, BGBl. I, 2676) states that whoever negligently or intentionally damages someone’s life, liberty, or property will be liable for compensation. “Wer vorsätzlich oder fahrlässig das Leben, den Körper, die Gesundheit, die Freiheit, das Eigentum oder ein sonstiges Recht eines anderen widerrechtlich verletzt, ist dem anderen zum Ersatz des daraus entstehenden Schadens verpflichtet.“

³⁷ For details, compare (Zweigert and Kötz, 1984) at pp. 340.

³⁸ *Ibid* at p. 404.

Summary and Comparison

To summarize, throughout the 19th century, courts were the primary agents to determine liability for tort actions. The nature of the cases that were litigated changed considerably during the course of this century. Courts in the UK, France and Germany recognized the need to adapt existing law to the new cases that arose as a result of technological change. This was done on the basis of the original lawmaking powers in the case of the UK and the residual lawmaking powers that were implied in statutory law, in the case of Germany and France. The scope of implied lawmaking powers differs somewhat from country to country. As explained above, France had the most general provision on tort liability. By contrast, in Germany tort liability is limited to damages of enumerated rights, although the code adds that “other rights” (*sonstige Rechte*) may also be protected. This opened the backdoor for protecting a range of rights, which the original lawmakers could not anticipate – even though the fact that such a broad term, which invited judicial interpretation was included in the law suggests that lawmakers were only too aware of their own limitations. In England the classification of torts into highly specified categories gives the appearance that the scope of tort law as well as the ability of courts to respond to a changing environment was rather limited. In fact, courts could and did change the types of cases they would hear, and thereby opened up tort law to new cases as they arose.

The major difference between the three countries is that France started off with the general presumption in favor of liability, at least where fault could be established. And with the recognition of guardianship as a cause for liability, the way towards strict liability had been paved. By contrast, English courts started with the presumption of no

liability, unless the injurer had breached some duty he or she owed to the victim. This principle was only gradually relaxed over time. Finally, German courts had substantial residual lawmaking powers, but less so than their French counter part. In light of the extensive legislative interventions that had preceded the enactment of the civil code, however, courts in Germany have been more deferential to the legislature than courts in France. Table 1 below summarizes these major differences.

Table 1: Allocation and Use of Lawmaking Powers in General Tort Law

	Original lawmaking powers	Allocation of residual lawmaking powers	Formal constraints on courts' lawmaking powers	Agent introducing major legal change	
				Negligence	Strict liability
England	Courts Legislature	Courts	Precedents and legislative prerogative limit court's lawmaking powers	Courts	(Courts) Legislature
France	Legislature	Courts	Broad code provisions establish few formal constraints	Legislature	Courts Legislature
Germany	Legislature	Courts	Fairly broad code provisions establish some constraints	Legislature	Legislature

Source: Compilation by authors

These differences notwithstanding, the above analysis suggests that while courts in all countries proved to be quite responsive to socioeconomic change, ultimately they were unable to effectively protect society from harm. All countries suffered a series of financial market failures and watched the number of those injured at work, on streets, or rails increase. While it might be possible to identify particular weaknesses in the court system of one of the three countries that made them less apt to respond to this challenge,³⁹ we propose that the real problem runs deeper. All three countries have designed courts as *reactive* law enforcers. Their power to enforce the law, as well as to adapt it to change depends on others bringing action. By implication, most cases are brought only *ex post*, i.e. after harm has been done. Moreover, parties may hesitate to bring action when the outcome is highly uncertain, as is invariably the case when law is highly incomplete – i.e. when cases arise that have not been adjudicated before. As a

³⁹ See, for example (Robb, 1992) for a critique on how English courts handled white collar crimes; and (Glaeser and Shleifer, 2003) who suggest that the rise of the regulatory state in the US occurred in response to high levels of corruption in the court system.

result, existing tort law could not effectively deter harmful actions. The major response to this problem was the emergence of agents that combined proactive law enforcement powers with residual lawmaking powers.

4. Allocating Lawmaking and Law Enforcement Powers to Regulators

The extent to which modern states have allocated lawmaking and law enforcement powers to agents with regulatory functions is remarkable. Describing the situation in the UK as late as 1950, Michael Moran notes that “regulatory standards covering the production and sale of food were skeletal” and while much economic life was regulated, it was regulated by self-regulators, such as the free profession, or the City of London.⁴⁰ By contrast, today “vast new areas of social and economic life have been colonized by law and by regulatory agencies. The food we eat, the physical conditions we work under, the machines and equipment we use in our home, office and on the road – all are increasingly subject to legal controls, usually administered by a specialized agency”.⁴¹

A similar story can be told for Germany and France as well as for other highly industrialized nations. The scope of safety and system regulation greatly expanded in all industrialized countries especially in the period following World War II. A plausible explanation for this trend is the risk created by the process of industrialization and development on the one hand,⁴² and the difficulties to deter all potentially harmful actions on the other (Pistor and Xu, 2003; Xu and Pistor, 2003). Frequently, the creation and

⁴⁰ [Author?](2001) To be sure, our definition of regulators includes self-regulators and the emergence of a large number of self-regulator organizations in areas that elsewhere were regulated by the state, may suggest a response to a similar problem, even though it differs in institutional detail.

⁴¹ *ibid* at p. 20.

allocation of proactive law enforcement powers followed a series of scandals, devastating accidents, or economic shocks. This is well documented for financial market regulation, which is typically introduced on the heels of scandals that cause major market downturns or even the (temporary) collapse of the market. The best example is the federal securities regulation in the US, which followed on the heels of the 1929 stock market crash.⁴³ More recently, the Sarbanes Oxley Act was a response to the law enforcement problems exposed by corporate scandals like Enron, Worldcom, Adelphi, etc..⁴⁴ Similar events occurred in other countries. In England, the parliament threatened on several occasions to regulate financial markets in the 19th century and again in the 1920s, unless stock exchanges as the major self-regulators increased their regulatory oversight.⁴⁵ While this threat did not materialize until 1986 with the “Big Bang” reforms, it strengthened the regulatory oversight of companies by self-regulatory bodies. And in Germany, the first comprehensive state regulation of stock markets, the 1896 stock exchange law, was a direct response to the crash of the founders’ boom.⁴⁶ It allocated regulatory oversight to relevant state agents at the level of the Länder (German states) and charged stock exchanges with scrutinizing companies before listing.

Similarly, the expansion of regulatory controls over hazardous chemicals in all major industrialized countries can be attributed to a series of disasters that occurred in the late 1960s and early 1970s, such as Soveto (Italy), Hopewell (Virginia, US), and Minamata (Japan).⁴⁷ Regulatory responses typically included approval requirements for the use of

⁴² (Beck, 1992; Giddens, 1990)

⁴³ (Seligman, 1983); (Coffee, 1984).

⁴⁴ (Bratton, 2002).

⁴⁵ (Michie, 1999).

⁴⁶ (Merkt, 1997).

⁴⁷ (Brickman, Jasanoff, and Ilgen, 1985).

new and potentially dangerous substances, the regulator's power to enjoin the production or use of particular chemicals and to amend the list of hazardous substances over time.

As the above examples suggest, a frequent response to crises that exposed the inability of existing law to effectively deter actions that could result in major harm to the public was the allocation of lawmaking and law enforcement powers to agents, which unlike courts could enforce law proactively. Proactive law enforcement entails the power to initiate law enforcement procedures independently of others. This includes not only the power to enjoin a specific action before harm has been done, but to impose entry barriers in the form of registration and approval conditions on a particular class of actions that are deemed potentially dangerous. To give proactive law enforcement sufficient bite, they are typically combined with the power to adapt existing rules to changes in the environment. Thus, regulators can adjust disclosure or merit rules companies must meet to enter the market, or change the list of potentially hazardous substances.

In Europe the growth of regulatory functions did not imply the creation of new regulatory agents to the same extent it did in the United States. Unlike in the United States, where the rise of the regulatory state is – rightly or wrongly⁴⁸ - closely associated with the creation of independent regulatory agents, in Europe until very recently⁴⁹ regulation was placed in the hands of the executive branch of government. This is evident, for example, in the area of environmental and safety regulation of hazardous chemicals. Table 2 lists the major agencies in charge of controlling chemicals in the UK,

⁴⁸ For a critique of this over-simplistic view, see (Strauss, 1984). In his words, “regulatory and policymaking responsibilities are scattered among dependent and executive-branch agencies in ways that belie explanation in terms of the work agencies do”, *ibid* at p. 584.

⁴⁹ The rise of the regulatory state has become subject of extensive scholarly analysis and debate only since about the mid 1990s. See, for example, (Majone, 1994).

France, Germany, and the US the scope of their regulatory powers and the date when these regulatory powers were created or expanded.

Table 2: Regulatory Functions and Agencies for Controlling Chemicals

	Regulatory Agency	Scope of Regulatory Oversight	Date when established/ regulatory powers conferred
France	Ministry of Agriculture	Food additives Pesticides	1977 Chemical Notification Law
	Ministry of the Environment	Notification of the use of toxic substances	
Germany	Ministry of Agriculture	Pesticides; efficacy testing and registration	1971 Environment Program launches series of legislative acts expanding regulatory oversight
	Health Ministry	Regulation of pesticides, residues, new food additives	
	Federal Health Office	Toxicological evaluations; advise to federal health and agricultural ministry	1980 Chemicals Act
England	Ministry of Agriculture, Fisheries and Food	Food additives, pesticides	Established end of 19 th century Regulatory responsibilities expanded in 1970s
	Health and Safety Commission	Pre-market testing of new chemicals	
USA	Ministry of Agriculture	Regulation of pharmaceuticals	1906 Pure Food Drug Act
	Food and Drug Administration		1938 Federal Food, Drug and Cosmetic Act

Source: Compilation by authors on the basis of (Brickman, Jasanoff, and Ilgen, 1985) and (Temin, 1992).

This general pattern is currently undergoing important change. A growing literature on the rise of the regulatory state in Europe suggests that many countries are now moving to creating new, independent regulators.⁵⁰ In part this trend may be motivated by the harmonization of law at the European level and the greater emphasis placed on the coordination among national regulators. In order to facilitate this process, increasing attention is being paid to streamlining regulatory structures, regulators' competences, and enforcement powers. This has gone hand in hand with making more detailed institutional

⁵⁰ (Majone, 1994; Thatcher, 2002).

demands on the design of such regulators in European harmonization directives.⁵¹

However, the jurisdiction of the EU over the design of national institutions is rather limited. In fact, sufficient differences remain across member states in the creation of “independent” regulators to suggest that EU sponsored reforms is only part of the story.⁵² Whatever the causes for the recent trend, the creation of “independent” regulators will require different governance structures from those that so far have dominated the European landscape. In the following section, we present a stylized account of alternative governance structures for regulators, which will then be used to analyze real world governance structures in different jurisdictions.

5. Governing Regulators

The notion that law is incomplete and therefore unable to effectively deter harmful actions at socially optimal levels helps explain why there is a need for regulators and what its major functions are. We now address the question of the governance structure over agents that combine proactive law enforcement with delegated lawmaking powers, i.e. the issue of regulatory regime choice. We distinguish two ideal types of regulatory governance structure: a vertical and a horizontal one. In the vertical governance structure agents carrying out regulatory functions are accountable to their superiors, who in turn are accountable to whoever appointed or elected them. By contrast, the horizontal governance structure lacks these clear lines of accountability. Instead, governance is effectuated by a variety of mechanisms, including restrictions on the scope

⁵¹ A recent example is the draft Market Abuse Directive, which requires that national regulators have the power to impose administrative sanctions. COM(2001) 281 final. 30 May 2001.

of regulatory functions or approval requirements, public participation and transparency, and extensive judicial review.

The two governance structures are akin to the debate in economics about the determinants of vertical integration and market transactions.⁵³ According to transaction cost theory, vertical integration occurs when the internalization reduces transaction costs, in particular when parties to the transaction make highly transaction cost specific investments.⁵⁴ Further closer to our analytical framework, hierarchy or vertical integration vs. markets or non-integration are analyzed as results of allocating property rights when contracts are incomplete. When parties are incapable of stipulating all future contingencies in their contract, it is necessary to determine who holds the right to decide future conflicts, i.e. who holds the residual rights of control. Should they be independent to each other (the case of markets) or should they be put into a hierarchical relationship (the case of integration)⁵⁵ The parallel to the governance structure of regulators is that when law is incomplete it is not possible to design effective governance structures that rely primarily on specifying regulatory tasks. Instead, additional governance mechanisms are needed. They may comprise of monitoring within hierarchy – the parallel to the integration of firms - inter-agency monitoring or competition, vesting individuals affected by regulators actions with the right to judicial recourse, and the like. A word of caution when applying theories of the firm in this context is however, in order. There are important differences between economic transactions and the design of legal institutions. In economics, incomplete contract theory (with some additional conditions) goes a long

⁵² (Gilardi, 2002).

⁵³ Williamson, *Markets and Hierarchies*, 1975.

⁵⁴ (Williamson, 1979),

⁵⁵ (Hart, 1995).

way in explaining when integration is optimal and when it may be better to use arms-length contracting. By contrast, to explain the governance of regulators in different countries we need to employ not only incomplete law theory, but understand the institutional, including constitutional constraints of each system. The reason is that in economics the two contracting parties are assumed to have free choice over designing their contract and allocating powers among them – or to decide that vertical integration might be superior to arms length transacting. Third party repercussions are non-existent or are assumed away. By contrast, the design of law as well as of lawmaking and law enforcement institutions not only has important third party effects, but can influence and/or be influenced by the process of political decision making. It is the function of the constitution to limit choices over the content of law and, perhaps even more importantly, over the allocation of the power to make, adjudicate, and enforce the law. These constitutional constraints are binding and cannot be freely re-negotiated, even though the precise boundaries of the jurisdiction of different branches of the government may be reinterpreted over time.⁵⁶ Still, the parallels between firm level governance and regulatory governance helps identify major features of alternative regulator regimes.

The ideal type of a hierarchical governance resembles an integrated firm. New functions, in this case proactive law enforcement and complementary lawmaking activities are created inside government, i.e. inside existing ministries or administrations. They might be fully integrated, or anew department with specified regulatory functions might be created. The bureaucrats in charge of regulation are subjected to similar lines of control as other departments, in particular to oversight by the command center, the

⁵⁶ On an interpretation of the US constitution that is consistent with the basic principles established in that document, yet takes account of the rise of the regulatory state, which had not been foreseen by the founding

government. The major line of defense by those subjected to regulation is some kind of review either by a special body within the relevant state bureaucracy, or by an independent court. While the former may have the advantage of greater expertise in the subject area, the latter offers more degrees of independence.

An alternative regulatory structure is to create new regulatory agents outside existing state administrations and to employ primarily horizontal mechanisms for governance purposes. They will explicitly not be subject to hierarchical lines of command and control. While this guarantees their independence and might make the combination of lawmaking and law enforcement functions within a single state body less problematic, it creates new governance problems. One governance device a lawmaker contemplating the delegation of lawmaking and law enforcement powers to an independent regulator might employ is to write a law that sets forth specifically the regulatory tasks. In writing this law, however, the legislature faces exactly the same incomplete law problem it confronts when writing any other law. Legislatures do not have unbounded foresight and will therefore inadvertently write an incomplete law. Incomplete law can result from too much specificity as well as from too much ambiguity. Specificity eases the monitoring and enforcement tasks, but reduces the ability of the regulator to adapt to a changing environment without seeking approval from the legislature. It also invites strategies to circumvent regulations. Ambiguity enhances the regulator's adaptability, but weakens monitoring and oversight by the legislatures, as well as other agents the legislature may employ, such as judicial review. Moreover, ambiguity raises the question of who holds the ultimate residual lawmaking powers to determine the proper scope of regulatory

fathers, see Strauss (1984), *supra* note [].

activities – the regulators or the courts.⁵⁷ Thus, the law that creates a regulator or “specifies” regulatory tasks is hardly sufficient as a governance device. Additional, external control mechanisms need to be created to reign in regulators should they expand their powers too much.

Each regime has its own costs and benefits. While the hierarchical governance structure may give the executive better control over the administration of regulatory tasks, it thereby vests the executive with substantial powers. Moreover, hierarchical controls often lack transparency and their effectiveness very much depends on the quality of the government in power.⁵⁸ Furthermore, with the growing number and complexity of regulatory tasks that are amassed by a single bureaucracy, monitoring and oversight within hierarchical systems becomes difficult and costly and relevant state agents might lack the incentives to perform adequately. A typical response observed in the private sector would be a spin off of some operation. Arguably, the recent trend in the European systems to create a number of so-called “independent” agencies can be interpreted to resemble such spin-offs.

By contrast, in lieu of effective internal controls the ideal type horizontal system has to rely to a greater extent on external governance mechanisms. One would therefore expect a greater role of the judiciary in ensuring accountability of regulators. In fact, it has been suggested in systems with independent regulators there is more extensive judicial control, but also greater participatory rights and oversight by citizens.⁵⁹ Citizen

⁵⁷ This issue has been subject of substantial debate in the US after the Chevron decision of the Supreme Court. For a more detailed discussion, see below [X].

⁵⁸ On a critique of the German internal governance model precisely for its lack of transparency and citizens’ participatory rights, see (Rose-Ackerman, 1995). For a critical review of this position compare [Peter Lindseth ADD].

⁵⁹ (McCubbins, Noll, and Weingast, 1987).

participation may also help address the problem of regulatory under-performance. There is obviously room for intrinsic motivation of bureaucrats in either system.⁶⁰ Yet, the right balancing between overzealous bureaucrats on the one hand, and too much slack on the other, might require some externally imposed constraints.

In the following section we will use this framework to analyze real world regulatory regimes. As will become apparent, none of the systems fits perfectly into one of the two ideal types. Interestingly, the resemblance with these ideal types was greater in the past, but has been weakened, as both systems have responded to the particular problems their initial regime choice posed. For the hierarchical system this has been the weakening efficacy of the internal governance structure given the growing number and complexity of regulatory tasks. For the horizontal system it has been the inherent weakness of legal controls caused by incomplete law.

6. Comparing Regulatory Regimes

We begin our analysis with a summary of the regulatory regimes in the three jurisdictions discussed above: the UK, France, and Germany. All three countries have traditionally used regulatory regimes that are fairly close to the hierarchical model. Canada follows the British system more closely than does the US, which is more of an outsider among the countries surveyed. In the other four countries regulators are controlled indirectly by the legislatures through its control over government. Courts

⁶⁰ For an extensive discussion of intrinsic and extrinsic motivation and a review of the empirical literature on the effect of, compare (Oserloh and Frey, 2000). See also (Landis, 1938) who points out that the danger of combining lawmaking and law enforcement functions in the hands of a single regulator may be countered by hiring a cadre of expert professionals and fostering a culture of professionalism.

exercise judicial review, but have limited their review mostly to questions of procedure and jurisdictional question and deferred substantive issues largely to the expertise of regulators. By contrast, the US system is the primary example for a horizontal regulatory regime structure. Increasingly, however, it has complemented external controls over regulators, including legislative oversight and judicial review with hierarchical controls exercised by the president and oversight bodies appointed by him. Table 2 summarizes the major differences in the governance of regulators in these five countries.

Table 2: Regulatory Governance in Comparative Perspective

Countries	Regulatory Regime Choice	Regulatory Discretion	Enforcement Mechanism
UK	Ministerial bureaucracy & Self-regulation	Broad delegated powers	Judicial review by general courts limited to <i>ultra vires</i> review
France	Ministerial bureaucracy	Broad rulemaking powers granted by constitution	Extensive review by Conseil d'Etat
Germany	Ministerial bureaucracy	Relatively narrow delegation of lawmaking powers	Review of violations of individual rights by administrative courts
US	Independent regulators & executive agencies	Initially restricted Expanded over time	Extensive judicial review by general courts
Canada	Ministerial bureaucracy	Broad delegated powers	Limited judicial review by general courts

United Kingdom

The UK has a tradition of allocating regulatory tasks to part of the existing state bureaucracy, which in turn is overseen by the government accountable to parliament. The creation of independent regulatory agencies is only a development of the last two decades. A description of the British regulatory system would, however, be incomplete without taking into account the scope of self-regulation. Until the Big-Bang reforms of 1986, financial markets were governed by a set of self-regulatory organizations,

including stock exchanges, and accountants. Similarly, the free professions were self-regulating without explicit government oversight. The major task of self-regulators, and a task they typically take up on their own initiative, is to regulate their own members. However, a number of self-regulators have also taken up the task of regulating third parties. A good example is stock exchanges vis-à-vis companies that wish to be listed on the exchange. With regards to the effect they have on third parties, SROs resemble in important ways state regulators. The emergence of third party regulation by self-regulators has frequently been a response to the lack of effective enforcement of existing law and legal institutions – i.e. to the same problem that has given rise to the emergence of state regulators.⁶¹

In the UK, the legislature has increased over time indirect and informal control over SROs. For the most part this has taken the form of threats to establish more stringent regulatory oversight and making this threat credible. In addition, the British legislature has frequently enacted standards that competed with those set by SROs and thereby forced them to raise their own standards and oversight. With respect to enforcing disclosure obligations for listed companies, for example, statutory law has greatly expanded the scope of mandatory disclosure requirements and exempted only companies that complied with higher standards established by the stock exchanges.⁶²

By contrast, there are only few formal external control rights over self- or state regulators. English common law courts have exercised considerable self-restraint in

⁶¹ This paper does not attempt to analyze the difference between self-regulators and state regulators. However, we would like to point out that self-regulation is an enforcement mechanisms that develops when other enforcement mechanisms are weak or not available. See (Bernstein, 1992; Greif, Milgrom, and Weingast, 1994). For a discussion of the limits of self-enforcement, see (Charny, 1990) and for the importance of the shadow of the state in limiting the danger of conflict of interest, see (DeMarzo, Fishman, and Hagerty, 2000).

⁶² See (Pistor et al., 2002) for a discussion of the 1927-8 and 1948 company act reforms in the UK.

reviewing regulatory actions – although this may be changing with the expansion of the regulatory state in the UK. Courts have usually taken the view that it is for the parliament to decide to whom to allocate lawmaking and law enforcement powers. The courts would respect this allocation and would only limit the scope of their judicial review to the observance of fundamental principles of due process, in particular the *ultra vires* principle.⁶³ The limited role of courts in reviewing regulatory actions may come as a surprise to those who believe that common law systems allocate much greater residual lawmaking powers to courts than civil law countries.⁶⁴ Yet, English courts have respected the primacy of the parliament’s power to realize its own claim to original lawmaking by enacting statutory law or by allocating residual lawmaking and law enforcement powers to different agents. English courts for the most part have therefore limited their role to protecting individuals from infringements of basic legal principles. Courts have drawn the limit where the legislature has tried to curtail even this limited scope of judicial review. Modern acts often state that the decision of the minister in charge shall be final or explicitly limit judicial review. However, in the case *Anisminic Ltd. V. Foreign Compensation Commission*, the House of Lord has held that such clauses do not necessarily exclude judicial review.⁶⁵ Given the long tradition of extensive judicial review by courts in England, the court argued, any restriction had to be interpreted in the

⁶³ A distinction is made between substantive and procedural errors, where a substantive violation of the *ultra vires* principle is found when decisions were made in bad faith or on the basis of false evidence. By contrast, a procedural violation occurs when the procedural requirements of the law are ignored, in particular when the administration ignores the right to be heard or notification of parties whose legal rights may be constrained (Schwarze, 1992)

⁶⁴ See, for example, (La Porta et al., 2001).

⁶⁵ 1 All ER 208, [1969] 2 WLR 163, (44 CLJ 126). The issue at hand was the determination of compensation for expropriation of property effectuated by a foreign power with which Britain had resolved the matter by bi-lateral treaty. The relevant provision of the 1950 code (section 4(4)) stated that “The determination by the commission of any application made to them under this Act shall not be called in question in any court of law.”

narrowest terms and any exclusive authority to review legislative or administrative actions that was allocated to a special administrative tribunal was to be interpreted to not undermine the review powers of the general courts.

The fact that the legislature has attempted to limit rather than encourage judicial review over regulatory action is interesting to note. It suggests that in its view courts do not play a crucial role as agents of governance over regulators. It may also be interpreted to mean that the legislature has other means to control regulators.⁶⁶ The most important devices include the review of administrative decisions by tribunals inside the administration and the strengthening of parliamentary oversight in the form of a new institution established in 1967, the Parliamentary Commissioner for Administration.⁶⁷ Yet, even these control mechanisms are weak by design. The commissioner is appointed by the prime minister and may act only when a member of parliament refers a matter to him. In other words, the commissioner facilitates internal review, but does not subject the administration to enhanced external scrutiny or formal legal controls that could be invoked by outsiders. As such, it is fully consistent with the internal control model of British administrative law. Most commentators suggest that in the traditional British system, these means consisted primarily of informal governance,⁶⁸ including vertical controls as well as dialogue and cooperation.⁶⁹

⁶⁶ Pablo Spiller suggests that in light of the restrained role of English courts, contracts rather than licenses have been used in the relation between regulators and the regulated (Levy and Spiller, 1994; Spiller, 1996). We differ in our analysis in that the focus of our research are not the instruments used by state agents vis-à-vis private agents (i.e. administrative acts or contracts), but the governance of regulators themselves.

⁶⁷ Parliamentary Commissioner Act, 1967.

⁶⁸ (Moran, 2001; Vogel, 1986)

⁶⁹ [ADD Black.]

Meanwhile, the UK has witnessed the “rise of the regulatory state”.⁷⁰ This trend entailed the replacement of traditional self-regulatory bodies with new state regulators, many of which are now designed as independent regulators. Thus, financial markets are governed by the Financial Services Authority, food safety is regulated by the new Food Standards Agency (created in response to the BSE crisis), and pharmaceuticals are controlled by the Medicines Control Agency.⁷¹ The key question the UK faces today is, whether the governance mechanisms that have been developed for a different model will be effective in ensuring compliance by increasingly independent regulators with parliamentary objectives. The first response to the new governance challenge has been a strengthening and increasing formalization of internal controls, so much so that books have been written about the rise of “regulation inside government”.⁷² Our theoretical analysis predicts that the creation of independent regulators should increase the use of external as opposed to internal control mechanisms. Observations in the literature suggesting that the number of court cases is increasing and that courts have enhanced judicial scrutiny of regulatory action⁷³ are consistent with this prediction. It will be particularly interesting to watch, whether the legislature’s perception of the role of judicial review of regulatory actions carried out by the new independent regulators will be changing.

France

⁷⁰ (Moran, 2001).

⁷¹ (Gilardi, 2002; Moran, 2001).

⁷² Hood et al (1999) at p. 23 estimate that by 1995 the regulation of government involved at least 135 separate regulators with 14,000 staff and cost over £700 per month to run. CHECK

⁷³ (Moran, 2001; Moran, 2002).

Just as in the UK, in France regulatory tasks are carried out by agents within the existing state bureaucracy. Unlike in the UK, this is the result not so much of delegation of regulatory powers by the parliament, but of the exercise of genuine lawmaking powers inside the executive. The French constitution of the Fifth Republic gives parliament only limited original lawmaking powers. Only those issues that fall within the domain of “laws” can be determined by act of parliament. All issues not specifically enumerated in the relevant provision of the constitution (Art. 34) fall within the prerogative of the executive, which implements its policies through regulatory decrees and ordinances (Art 37).⁷⁴ Moreover, the government has a strong hand in determining parliament’s legislative actions not only by initiating bills, but also by virtue of the fact that governmental proposals take precedence over bills proposed by private members of the parliament. In other words, it is not the parliament that delegates regulatory tasks, but it is the executive that has original lawmaking power in areas that the constitution deems not to be “laws”.

Consistent with the hierarchical model described above, the control mechanisms that were established are primarily internal. This reflects a strict separation of the executive and the judiciary that was established after the French revolution. The courts were explicitly denied the power to review administrative acts.⁷⁵ The constraints on judicial

⁷⁴ Art. 37 states explicitly that all other matters are regulatory in nature (“Les matières autres que celles qui sont du domaine de la loi ont un caractère réglementaire. See also (Schwarze, 1992).

⁷⁵ See Law (relating to judicial organizations) of August 16-24, 1790, Art 13: “Les fonctions judiciaires sont distinctes et demeureront toujours séparées des fonctions administratives. Les juges ne pourront, à peine de forfaiture, troubler, de quelque manière que ce soit, les opérations des corps administratifs, ni citer devant eux les administrateurs pour raison de leurs fonctions.” [The functions of the judiciary are distinct from and shall be always separate from administrative functions. The judges shall not, at the threat of forfeiture, interfere in any way whatsoever, with the operations of the administrative corps, and may not require administrators to justify their functioning in front of the courts]. As quoted in (Schwarze, 1992) p. 100 note 3. The denial of judicial review of executive acts has a long history in France, which predates the revolution. Already in the early 15th century were these disputes resolved in front of quasi-judicial

lawmaking and law enforcement powers thus went much further with respect to administrative than private law. As discussed above, the code civil leaves at least implicitly extensive lawmaking powers in the hands of the courts by using broad and ambiguous language, especially in the area of tort law. By contrast, the review of administrative decision-making, rules and regulations is left to a special body, the *Conseil d'Etat*, a unique invention of the French system, which was established in 1799. Originally, the *Conseil* did not have any adjudicative functions, but was designed as a consultative body to the government. Only in 1872 was a special litigation section created. Civil servants rather than judges serve even in this section. Nevertheless, today it is widely acknowledged that the litigation section of the *Conseil* functions largely as an independent administrative court.⁷⁶ In addition to reviewing administrative rules and regulations ex post, the *Conseil* also review proposed bills ex ante. Every bill introduced in parliament must be submitted to the *Conseil d'Etat* for advice.⁷⁷ In this case, the advice is not binding, but the procedure nevertheless, gives this institution some ex ante control over lawmaking. Moreover, the *Conseil* must be consulted about delegated legislation designed to fill gaps left in the relevant parent legislation.⁷⁸

Given the extensive *original* rulemaking powers of the executive, it is not surprising to find that administrative decision making is not governed by a comprehensive statutory law. Although a trend to codify areas of administrative law has been noted,⁷⁹ these codifications typically organize existing rules, regulations, and case law in a systematic

administrative organs rather than in the general courts. It has been suggested that the doctrine of the separation of power, which gained new currency after the French revolution lent this old tradition new theoretical justification rather than constituting a break with the past. See (Woehrling, 1985).

⁷⁶ (Schwarze, 1992)

⁷⁷ (Obe and Bell, 1993) at p. 61.

⁷⁸ Ibid at p. 62.

fashion, but do not add much. As a result, much of the French administrative law is case law as developed by the *Conseil d'Etat*. Its decisions are considered binding on the administration and deviations are “punished” with nullification of the relevant acts.

Aggrieved citizens can bring actions against the state administration. The first step is usually to apply for internal administrative review. Then, the matter will be mediated by a government appointed mediator, an office which was created in the early 1970s. If this does not resolve the matter, it can be referred to *tribunaux administratifs*, which since 1953 law have functioned as administrative courts of first instance. The *Conseil d'Etat* can be called upon to review the legality of their decisions in an appellate procedure.

In summary, in France the executive has extensive original lawmaking powers. The major constraints on the use of these powers are civil and political rights enshrined in the constitution. The major function of administrative law as developed in the *Conseil d'Etat's* jurisprudence is the supervision of the functioning of the state apparatus. The supervisory function is not carried out by the legislature, nor by the courts, but by a special agent, the *Conseil d'État*, which itself forms part of the central state apparatus, but functionally separate from it. As other countries in Europe, France is currently contemplating outsourcing major regulatory activities to independent regulatory bodies outside the traditional state administration. In principle, however, this should not affect the role of the *Conseil d'État* as the major oversight body. [CHECK]

Germany

⁷⁹ Examples include the Code de l'administration communale, the Code de l'environnement, and the Code de l'urbanisme (ibid at p. 104). See (Schwarze, 1992).

Under the Weimar Constitution of 1918, Germany's first democratic constitution, parliament was vested with the primary lawmaking power. The extent to which the legislature could delegate lawmaking to the state administration was disputed. The German Supreme Court of the time (*Reichsgericht*), however, did not object to far-reaching delegation. The only conditions were that the delegation had to be "somehow limited in duration, subject matter, and persons affected" – conditions that were widely regarded as being too lax to be meaningful in practice.⁸⁰ The parliament made quite extensive use of the right to delegate lawmaking to administrative agencies in a series of "empowerment statutes" (*Ermächtigungsgesetze*), which were limited in duration, but granted sweeping powers to the executives to address the needs of the people during the Republic's numerous political and economic crises. One of the last these delegating statutes brought an end to the Weimar Republic by empowering the Hitler government to take over essentially all lawmaking functions.

In light of this history, it is not surprising that Germany's new constitution, the 1949 Basic Law of the Federal Republic of Germany explicitly constrains the right of the legislature to delegate lawmaking and the scope of the administration's lawmaking powers. In principle, all acts that may constitute an infringement of the civil and political rights enshrined in the *Grundgesetz* (GG) must be based on a statute passed by parliament. Such a statute may authorize the federal government, a federal minister, or the governments of the Länder to issue regulations. Note, that independent regulatory agencies are not mentioned. Moreover, the statute must determine the content, purpose, and scope of such authorization and the regulation itself must specify its statutory basis. Finally, if the statute provides that the authority may be delegated further (i.e. to lower

⁸⁰ (Kischel, 1994) at p. 229.

echelons of the administration), this delegation may be done only by regulation, not internal orders.

The system as set up by the constitution thus is one that requires the legislature to be fairly specific when delegating regulatory functions to the administration – a control device we have associated with horizontal governance models. In light of Germany’s experience with excessive parliamentary delegation of rule making activities, this is not surprising. At face value, however, it limits the administration’s scope of discretion as well as its ability to respond to changes in the environment without explicit legislative authority. Not surprisingly, the system has come under attack in areas such as environmental law, which are more fluid and require greater responsiveness by agents who hold residual lawmaking powers.⁸¹

In reality, however, there is more flexibility in the system than the constitutional set up might suggest. Whether a statute does clearly circumscribe content, purpose and scope of future regulations has become subject of much litigation and judicial review. This supports our proposition that inherent incompleteness of law limits the ability of legislatures to use the delegating law as a major constraint on regulatory activities. In resolving disputes over the scope of regulatory authority when the law is incomplete, the supreme administrative court relies on a theory of “essentialness” (*Wesentlichkeitstheorie*), which asks whether the specification in the law are sufficient to make the contents of the regulation predictable.⁸² This, of course, is a rather open ended standard. Moreover, courts use different standards depending on the nature of the issue that is

⁸¹ See (Schwarze, 1992). For a different critique, focusing on the lack of judicial review and citizens’ participatory rights, see (Rose-Ackerman, 1995).

⁸² (Kischel, 1994) (at p. 233).

being regulated. Where basic civil or political rights are involved, the standards are more stringent than where this is not the case.

Administrative acts are subject to judicial review by the administrative courts after the internal administrative review mechanisms have been exhausted.⁸³ The focus of administrative judicial review is on the protection of citizen's individual rights. Standing is limited to claims that a particular act violates the plaintiff's individual rights. In the course of the review administrative courts may, however, strike down regulations enacted by the administration that were not sufficiently authorized by statutes passed by the legislature. In fact, this is a quite frequent occurrence, especially when compared to similar cases in France or the US.⁸⁴

Germany has also followed the recent European trend of establishing specialized agencies and allocating to them specific regulatory tasks. An example is the federal commission for securities, which was established in 1994. The powers of these agents, however, are relatively limited. Moreover, they often work directly under the supervision of ministries, just as other parts of the state bureaucracy. Existing constitutional constraints on the delegation of rule making authority effectively limit the ability of the legislature to vest independent regulators with greater rule making authority. Similarly, enforcement activities that go beyond the revocation of licenses and the like typically require endorsement by the judicial apparatus.

Canada

⁸³ Internal review must precede litigation. It is typically carried out by the direct superior of the official who has issued the original act. For details, see [ADD].

⁸⁴ (Kischel, 1994) ADD.

Canada follows closely the European model in the governance structure of regulatory functions. Only few constraints limited the scope of delegated lawmaking historically. A law on this matter was passed only after World War II. Before then, delegation faced few formal legal constraints⁸⁵ An important feature of the Canadian system is that draft regulations are reviewed by the Privy Council Office prior to their adoption to ensure consistency with existing statutory law and the constitution.⁸⁶ In 1986 a special secretariat for regulatory affairs were established in the Privy Council Office and a minister responsible for internal affairs was appointed, enabling the Privy Council to exercise greater scrutiny over regulatory rule making. In addition, regulatory acts are subject to judicial review and Canada has a well developed body case law on the appropriate scope of delegating lawmaking powers to administrative agents. Delegated lawmaking is not only a matter of federal law, but takes place also at the state and municipal level. In Quebec, for example, the first law on delegated lawmaking was enacted in 1986 – much later than in other provinces.⁸⁷ It uses a very broad and abstract definition of regulation. The most important control mechanism seems to be ex ante control of proposed regulation by the Ministry of Justice. Only after it has been approved and published does a regulation come into effect. In this age of increased regulatory lawmaking it would be interesting to review regulatory practices in different Canadian provinces and to analyze how governance structures used in Quebec compare with

⁸⁵ Historically, an interesting feature of the Canadian system has been that parliament delegated legislative powers first to the judiciary (the magistrates) rather than the executive. Examples include the 1792 Act to Prevent Accidents by Fire, the 1797 Act for the Regulation of Ferries. See (Holland and McGowan, 1989). The authors suggest that “this would be considered both unusual and improper today” (at p. 8).

⁸⁶ CHECK for origins of this feature.

⁸⁷ The section relies primarily on (Holland and McGowan, 1989).

governance structures employed in other provinces and how they may affect the quality and outcome of such regulation.

As a general matter, however, the increasing importance of regulation in most modern economies suggests that the traditional separation of common law and French civil law may become less decisive over time. As should be clear from the analysis of the three European jurisdictions above, the regulatory governance devices might differ in details, but their basic typologies are quite similar across jurisdictions, and more importantly, across legal families. The major unifying factors were that regulatory functions were assumed by already existing administrations. The creation of “independent” regulators is only a fairly recent phenomenon. The main governance structure that still dominates are hierarchical controls supplemented by judicial review. Yet, the form of hierarchical controls and the scope of judicial review differs from country to country. To curtail the regulators’ discretionary powers such a system may create, the UK has used primarily informal control mechanisms – although this system is increasingly giving way to greater formalization and an expansion of intra-government regulation. France created a special internal governance organization staffed with civil servants. Over time, this internal control apparatus has assumed extensive judicial-like review functions to ensure the proper functioning of the state administration. Germany uses a combination of legislative oversight, which is mandated by the constitution, informal controls, and judicial review, which albeit somewhat narrow in scope has been used quite effectively in the past to overturn regulatory actions, including regulatory lawmaking. Still, when compared with the US model, the similarities across these three countries outweigh their differences. As discussed, there are signs that this is changing

and that the UK in particular is in a process of not only outsourcing more regulatory tasks to independent regulators, but also of enhancing external controls, in particular judicial review as internal control devices have become exceedingly costly.

United States

In the United States, the rise of the regulatory state is most closely associated with the New Deal under the Roosevelt administration, even though a number of independent agencies had been established earlier, including the Interstate Commerce Commission of 1887, or the Federal Trade Commission in 1914.⁸⁸ What made the New Deal different was a new political philosophy about the function of law and the proper allocation of lawmaking functions within existing constitutional constraints. Whereas traditionally the primary function of law had been to enforce existing property rights, law was now to be used also as an instrument of re-distribution.⁸⁹ In areas where prevention rather than redistribution was the primary policy objective, technocrats with specialized expertise rather than judges were given the power to specify, interpret, and enforce these policy objectives.⁹⁰

The regulatory system that was designed at the time resembles in many ways the ideal type of a horizontal governance structure of regulators described above.

Independent regulators cannot be controlled with the same devices that work quite effectively in a hierarchical setting, such as reward and punishment – be they formal or informal - within clearly established vertical lines of control. Initially, it was hoped that intrinsic control devices, in particular the professionalism and technocratic expertise of

⁸⁸ For an overview of the history of regulation in the US, see (Stewart, 1975).

⁸⁹ (Sunstein, 1987).

regulators would suffice to ensure compliance with the legislated mandate.⁹¹ Thus, legislative controls were often limited in the delegating legislation. This, however, proved difficult. For some regulators their powers were clearly circumscribed in the law. Many regulators, however, were given broad lawmaking and law enforcement powers.

Creating independent agencies outside the existing state bureaucracy immunized these agents to some extent from control by the executive. At least in part this was a response to existing constitutional constraints as interpreted by the Supreme Court. The US constitution vests Congress with lawmaking powers. In fact, when striking down the National Industry Recovery Act in 1933 and 1935 the Supreme Court held that Congress could not freely delegate lawmaking powers. At the very least, it had to set the relevant standards itself.⁹² These decisions notwithstanding, the powers of regulators were greatly expanded over time.⁹³ This is true in particular in areas we are most interested in, i.e. regulations aimed at protecting the public from externalities arising from potentially dangerous operations or the use and emission of dangerous substances⁹⁴ Some laws mandated pre-approval obligations, others required regular review of regulatory performance in lawmaking and law enforcement. However, these legislative control mechanisms have not been used very extensively.⁹⁵ Procedural controls and other

⁹⁰ See also (Stewart, 1975).

⁹¹ This belief found one of its strongest advocates in (Landis, 1938).

⁹² *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1933); *A.L.A. Schlechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).

⁹³ Sunstein suggests that the courts simply succumbed to political pressure that demanded regulatory intervention [ADD]. An alternative interpretation would be that the delegation of lawmaking powers to independent agents was perceived to be less problematic as it did not challenge the separation of powers under the constitution.

⁹⁴ (Epstein and O'Halloran, 1999). See in particular Table 5.4 "Acts with Lowest and Highest Delegation Ratio. In the first category is tax law, social security law, and civil rights act; in the latter the water quality act, the clean air act, and the air quality act, among others.

⁹⁵ (McCubbins, Noll, and Weingast, 1987). See also Epstein and O'Halloran (1999) pp. 21. Note, however, that other studies have shown that political control by Congressional committees over regulatory action can

constraints on regulatory agencies increasingly substituted for substantive delimitation of administrative action.

This procedural governance structure was institutionalized with the adoption of the Administrative Procedure Act in 1946. The Act requires regulators to ensure public participation, give reasons for the acts they take, and ensure proper review both inside the administration, and ultimately judicial review. The Act thereby formalizes multiple channels of accountability. Given the regulators' independence, vertical control was not an option and monitoring by Congress alone proved costly to be effective.⁹⁶ Moreover, limiting the scope of regulatory powers by writing a highly specific law faced the problem of incompleteness of this law. Even where possible, it impeded the regulator's ability to act promptly and respond flexibly to a changing environment – a major benefit of lawmaking by regulators as opposed to legislatures. The use of multiple avenues of accountability, including particular participation rights and judicial review implied that Congress did not have to carry the burden of regulatory oversight alone. Instead, the responsibility for regulatory governance is shared with those subject to regulation who may challenge in court the failure by regulators to comply with the established constitutional constraints.⁹⁷

The system is by no means perfect. Reigning in overzealous regulators is not always easy, nor have regulators always lived up to the task of effective law enforcement, as only recently witnessed in the world of finance.⁹⁸ Arguably it is at least as vulnerable

be quite powerful. Weingast and Moran (1983), for example show that Congress through specialized sub-committees exercises substantial control over the Federal Trade Commission

⁹⁶ The problem of monitoring costs is stressed by (McCubbins, Noll, and Weingast, 1987).

⁹⁷ (McCubbins, Noll, and Weingast, 1987) argue extensively that the procedural devices were used to limit the cost of active Congressional monitoring and oversight.

⁹⁸ Major actions were brought by New York's General Attorney, Eliot Spitzer, rather than by the then chairman of the Securities and Exchange Commission (SEC), Harvey Pitt. See Andy Serwer and Julie

to failure – i.e. under- or over-enforcement when compared to socially optimal levels - than the hierarchical models described above. Yet, such hierarchical models were not feasible given existing constitutional constraints in the US, in particular the non-delegation doctrine.

The scope of judicial review has been subject to much controversy, both among courts and academics. Particularly problematic is the extent to which courts may substitute their own judgment in substantive matters for that of regulators. In exercising judicial review, US courts have at least originally exercised less self-restraint than British courts. This appears to be at least in part a function of the different constitutional framework in which they operate. British courts operate in a system that gives parliament control over the executive and thus is less adverse to delegating lawmaking to the executive. By contrast, US courts operate in a system that gives democratic legitimization to both the president and Congress, and vests one with executive powers, the other with lawmaking powers. Not surprisingly, US courts have scrutinized the substantive justification for regulatory intervention to a greater degree under the “hard look doctrine”, which imposes on regulators the need to justify their intervention with detailed cost benefit analyses. Courts have also substituted the regulator’s judgment with their own. A departure from this – in comparative perspective quite extensive – judicial review has been the Chevron case decided by the Supreme Court in 1984.⁹⁹ In this case, the Supreme Court held that courts could not simply replace the regulator’s judgment with

Schlosser, Wall Street Story: There’s a Rumble Between Harvey Pitt and Eliot Spitzer. Is Wall Street Big Enough for Both of Them? *Fortune*, June 8 2002 at p. 28.

⁹⁹ 467 U.S. 837 (1984). For a detailed analysis of this case and its aftermath, see (Merrill and Hickman, 2001).

their own. To the extent Congress has vested regulators with powers and they act in accordance with these powers, courts should defer to administrative competence.

In the twenty years since *Chevron* the governance structure of regulators in the United States has undergone further change. One can be described as the regulators' flight into informality, the other as the strengthening of presidential control. The horizontal governance structure of the US system described above has imposed substantial costs on the regulators. In particular, it has considerably slowed down the process of rulemaking, thereby undermining one of the greatest advantages of a regulator, namely to flexibly adapt existing rules to a changing environment. In response, regulators have taken flight into informality. Rather than expounding explicit rules, agencies have increasingly used informal non-binding guidelines to suggest what actions they might take in case of violations. At the same time, the flight into informality has raised the specter that regulators may once again escape accountability.

The second trend is the rise of the "presidential administration".¹⁰⁰ The clearest sign has been the creation of the Office of Management and Budget (OMB) during the first Reagan administration.¹⁰¹ In the terms of analysis, OMB resembles a super-regulator. All agencies are required to submit to the OMB's Office of Information any proposed major rule for pre-publication review. This allows OMB to take proactive steps in enjoining regulatory lawmaking before it is being implemented. Each submission has to be accompanied by a regulatory impact analysis, which must give a cost benefit analysis of the chosen strategy, allowing OMB to exercise substantive oversight over regulatory rulemaking. Subsequently, agencies were even required to present rulemaking

¹⁰⁰ (Kagan, 2001). See also (Sunstein, 1987) making a strong case for enhanced presidential oversight over regulatory actions.

plans for forthcoming years, allowing the presidential administration to directly influence this process.

This development is transforming the governance over regulators from a horizontal to a more vertical structure. Multiple horizontal control mechanisms may have ensured that regulatory powers were not misused. However, they have come at substantial costs. Moreover, they created a control vacuum with respect to setting regulatory policy agendas, which the presidential administration has gradually filled. The transformation of the US model into a more hierarchical governance structure is by no means complete. The above analysis only indicates a trend. The Presidential administration has not replaced judicial review, public participation, or Congress's power to review the scope of delegated regulatory tasks. The trend does, however, suggest that the horizontal model is costly and difficult to sustain – important lessons especially for countries that are only now witnessing the rise of the regulatory state. Regulatory accountability is a much more complex task in this model than in the vertical control model as it requires the design of proper incentives for different agents that are expected to participate in the governance task. Even where it succeeds in effectuating negative control against abuse, it seems vulnerable to the usurpation of positive control by different actors – be they part of the government (i.e. the president) or private agents (i.e. powerful interest groups).

7. Conclusion

¹⁰¹ (Sunstein, 1987) pp. 454 and (Kagan, 2001) pp. 2277.

In recent years much has been made of the difference between common law and civil law countries in determining financial market development,¹⁰² good governance,¹⁰³ and ultimately economic growth.¹⁰⁴ Most of these empirical studies concluded that common law countries were superior to civil law countries and have related these findings to institutional differences, in particular to the role of courts and their relation to the government.¹⁰⁵ Over the past century, however, agents other than courts have come to play a crucial role in lawmaking and law enforcement. We argue that the rise of the regulatory state is a response to the inability of the traditional law enforcement agency, the courts, to effectively deter socially harmful actions. We observe the rise of regulatory functions in different jurisdictions irrespective of their legal origin. However, we do note that different countries employ different governance strategies to mitigate the problems that arise when extensive lawmaking and law enforcement powers are placed in the hands of a single, albeit specialized agent. While there are variations in detail, we single out two ideal types of regulatory governance, a hierarchical and a horizontal one, noting that the jurisdictions we have analyzed increasingly combine features of both to address the tasks posed by the rise of the regulatory state.

Recall that the starting point of our analysis was that just as contracting parties are unable to write complete contracts, so lawmakers are unable to write complete laws. Unless lawmakers allocate some residual lawmaking powers to others, in particular to agents in charge of enforcing the law, law enforcement is likely to be ineffective as

¹⁰² (La Porta et al., 1997; La Porta et al., 1998)

¹⁰³ (La Porta et al., 1999)

¹⁰⁴ (Mahoney, 2001).

¹⁰⁵ (Glaeser and Shleifer, 2001).

technological and socioeconomic change will render existing law exceedingly incomplete and offer new arbitrage opportunities for agents to escape the reach of the law.

Traditionally, the most important agents that exercised residual lawmaking powers were courts. This is true for all countries analyzed, irrespective of legal origin. Over time, however, regulators have come to play an increasingly important role as residual lawmakers and law enforcers. We argue that their major advantage over courts is that unlike courts they can enforce law proactively and that they can make rules *ex ante*, which enhances their ability to prevent harm as opposed only remedying harm after it has been done.

Using regulators to optimize law enforcement to socially desirable levels assumes that regulators are social welfare maximizers, or at the very least, that they share the same objectives as legislatures. In the real world this is unlikely to be the case. The key question then become how the principals who delegate lawmaking and law enforcement powers to regulators can make sure that regulators stay as close to their objectives as possible. In theory they have two options: they may use hierarchical internal controls or they may use horizontal devices (more akin to contracts than commands) and decentralized mechanisms of accountability to control the regulators. Effective hierarchical or internal controls are available only in systems where the legislature has real leverage over the state administration. Even then, the efficacy of this model may be challenged by the growth of regulatory tasks, both in number, and in complexity. Alternatively, the legislature may attempt to write a highly complete law to control regulatory discretion and monitor compliance either itself or, by delegating monitoring to others, including to those that are being regulated. Limiting regulatory discretion by

writing a complete law is not feasible for reasons explained. Moreover, keeping regulators on a short leash constraints their ability to make the most of their proactive lawmaking and law enforcement powers. Other governance devices must be sought to retain the benefits of a flexible regulator while ensuring optimal levels of compliance. One of the most important monitoring devices used in the horizontal system has been judicial review initiated by affected individuals, as well as extensive citizen participation in lawmaking processes. By contrast, hierarchical governance structures rely primarily on internal controls and make comparatively less use of judicial review.

Our comparative analysis suggests that both ideal regulatory regimes – the hierarchical or internal model on the one hand, and the horizontal, or external governance model on the other – create their own costs. Reforming and adapting the governance structure is an ongoing process in all countries, albeit arguably to a greater extent in the US and the UK than – so far - in either Germany or France. In adapting their existing governance structure, each country faces the challenge of finding new solutions given its own constitutional constraints. As Levy and Spiller¹⁰⁶ have pointed out, what appears to be important is the “fit” of the chosen governance structure, not its inherent superiority.

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¹⁰⁶ (Levy and Spiller, 1994)

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