OUTSOURCING GOVERNMENT REGULATION

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INTRODUCTION

Regulation is not just for bureaucrats anymore. The government has increasingly relied on private means to achieve public ends, not only involving services to the public, but the origination and implementation of regulatory policy as well, which is the primary focus of this Essay.¹ While this trend has the potential to improve governmental performance, it also has the potential to cause government failure, as several recent events remind us. In the aftermath of the horrific events of September 11, 2001, it was revealed that the Federal Aviation Administration (FAA) had delegated responsibility for airport security to the nation’s airlines, which in turn had hired private firms that failed to provide an adequate level of security.² More recently, as a reaction to Enron and other recent financial scandals, Congress prohibited the accounting industry from writing the accounting and auditing standards used in government-mandated financial disclosures, and it established a new administrative agency to adopt such standards.³ Still more recently, the Securities and Exchange Commission (SEC) has found evidence

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² See infra notes 95–96 and accompanying text.

³ See infra notes 75–78 and accompanying text.
of the failure of self-regulation at the American and New York Stock Exchanges.\textsuperscript{4}

These public policy failures highlight the importance of understanding when and where the involvement of private parties is likely to serve the government's objectives, and when it is not. This Essay proposes that a transaction cost analysis is useful in comparing the relative merits of government employees and private actors,\textsuperscript{5} and that application of this framework suggests that a reasonable degree of skepticism is appropriate about the practice of outsourcing government regulation.

Transaction cost analysis is associated with the work of Professor Oliver Williamson and his efforts to understand when economic actors will engage in complicated contracting to purchase goods and services, and when they will internally produce those goods and services.\textsuperscript{6} This is often described as the "make-or-buy" decision.\textsuperscript{7} Williamson has offered some preliminary thoughts on how the same analytical tools can explain the institutional structure of public agencies.\textsuperscript{8} This Essay proposes that the government's decision to rely on private means in a regulatory context is a type of make-or-buy decision. When it makes this decision, an agency must determine whether to produce and implement regulatory policy inside the agency or involve private actors in these functions. It then uses transaction cost analysis to develop a normative framework that suggests when the government should outsource regulation.

My analysis proceeds as follows. The first two Parts of the Essay explain the basic conceptual tools of transaction cost analysis, how these tools account for the actions of private actors, and why these

\textsuperscript{4} See infra notes 144-46 and accompanying text.

\textsuperscript{5} An earlier and more limited attempt to establish this claim can be found at Sidney A. Shapiro, Matching Public Ends and Private Means: Insights from the New Institutional Economics, 6 J. SMALL & EMERGING BUS. L. 43 (2002). Professor Freeman briefly suggests the possible utility of a transaction cost approach. See Jody Freeman, The Private Role in Public Governance, 75 N.Y.U. L. REV. 543, 573 n.108 (2000) (acknowledging the potential applicability of transaction cost analysis).


\textsuperscript{7} See, e.g., Thomas B. Leary, The Dialogue Between Students of Business and Students of Antitrust, 47 N.Y.L. SCH. L. REV. 1, 13 (2003) (referring to the make-or-buy decisions made by a rational company).

tools are helpful in evaluating the rationality of outsourcing government regulation. Part I explains how Williamson and others link the institutional structure of economic organizations to transaction costs. Part II contends that regulatory agencies confront the same type of make-or-buy decision as private firms and proposes a typology of private involvement in government regulation, which reveals that the government can write and enforce its regulations, or it can involve private actors in one or both of these functions.

Parts III through V evaluate when private involvement is more or less likely to lower an agency's transaction costs in each of the three categories of private involvement identified in the typology presented in Part II. Part III explains when an agency can reduce its overall transaction costs by involving private actors in writing regulatory standards. Part IV discusses when an agency can reduce its overall transaction costs by hiring private actors to enforce regulations and by negotiating with regulated entities concerning the scope of enforcement. Finally, Part V considers when an agency can reduce its overall transaction costs by relying on self-regulation by an industry. The analysis in each of these sections focuses on the impact of incomplete contracts, opportunistic behavior, and hold-up problems in determining the agency's transaction costs.

This Essay concludes by summarizing the results of the previous analysis, which leads to three conclusions. First, there is no a priori reason to conclude that outsourcing of government regulation will decrease the government's overall transaction costs because outsourcing is less costly in some cases and more costly in others. Second, using government employees will often be the least costly option because relying on private parties commonly involves incomplete contracts, opportunistic behavior, and hold-up problems, which significantly increase the government's transaction costs. Finally, the decision to rely on private parties in circumstances where the transaction costs are greater than using government employees is a function of ideological or political motivations that are inconsistent with the optimal implementation of the agency's regulatory mission.

I. ECONOMIC INSTITUTIONS

Transaction cost economics focuses on how economic actors overcome collective action problems that prevent mutual gains in trade. This Part describes the basic concepts of transaction cost analysis— incomplete contracts, opportunistic behavior, and hold-up
problems—and how such factors determine the nature of economic institutions. It builds upon the seminal work of Oliver Williamson, who has explained how the previously described factors determine when a firm will move from reliance on contracting to internal production of goods and services.\(^9\)

Professor Ronald Coase inaugurated transaction cost analysis by observing that a business may be able to reduce its costs by bringing transactions within the firm and avoiding the costs of negotiation involved in using markets.\(^10\) Coase's insight was that rational economic actors make this make-or-buy decision on the basis of which option has the lowest transaction costs.\(^11\) Transaction costs are "anything that impedes the specification, monitoring, or enforcement of an economic transaction."\(^12\) Since Coase, economists have explored how transaction costs determine the extent to which firms will engage in simple market transactions, more complicated contractual arrangements, or vertical integration.\(^13\) The goal is to identify the properties of transactions that explain specific institutional arrangements.\(^14\)

A firm's make-or-buy decisions reflect a series of decisions about contractual risks illustrated by Figure 1.\(^15\) A firm can purchase a good or service in a market transaction without the benefit of negotiating contractual protections for itself in an "unassisted market" transaction, which is node A.\(^16\) If there is a risk of imperfect performance by the other party, the index of contractual hazard (K) becomes greater than zero.\(^17\) The firm can seek to buy the good or service at a discounted price that reflects this risk, which is the "unrelieved market" at node B.\(^18\) Because this choice does not involve any contractual safeguards, the cost of such safeguards (S) is zero. If this solution is not sufficient to safeguard the interests of the firm, it

\begin{itemize}
  \item \(^9\) WILLIAMSON, supra note 6, at 30-32.
  \item \(^11\) Id. at 396–98.
  \item \(^12\) AVINASH K. DIXIT, THE MAKING OF ECONOMIC POLICY: A TRANSACTION-COST POLITICS PERSPECTIVE 38 (1996).
  \item \(^13\) See HENRY N. BUTLER, ECONOMIC ANALYSIS FOR LAWYERS 685 (1998) (noting that a "great deal" of law and economics research is built upon Coase's original insight).
  \item \(^14\) Brian Dollery, New Institutional Economics and the Analysis of the Public Sector, 18 POL'Y STUD. REV. 185, 192 (2001).
  \item \(^15\) Figure 1 is drawn from Williamson, supra note 8, at 314.
  \item \(^16\) Id. at 315.
  \item \(^17\) Id.
  \item \(^18\) Id.
\end{itemize}
will seek to negotiate a contract with another firm that anticipates potential problems and attempts to address them in the contract. I will refer to this situation as "hybrid contracting" (node C) in order to distinguish it from "classical" contracts where there is no cost associated with contractual safeguards.¹⁹ A firm will resort to internal organization (node D) only when this option has lower transaction costs than hybrid contracting.²⁰ The last two decisions—hybrid contracting or reliance on internal organization—involve the make-or-buy decision that is analyzed by Williamson.

**FIGURE 1**
**INSTITUTIONAL DECISION TREE**

Internal organization may be less expensive than hybrid contracting because of transaction costs associated with three aspects of contracting. First, the parties' collective action may be impeded by each actor's self-interest. Self-interest may involve an open and honest attempt by an economic actor to exploit its skills and assets, or it may involve an effort to "mislead, distort, disguise, obfuscate, or otherwise confuse" when it is advantageous to do so, which Williamson describes as "opportunism."²¹ In either case, the possibility of self-interested behavior increases "measurement" costs, or the costs of monitoring and evaluating performance of the other

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¹⁹. See WILLIAMSON, supra note 6, at 32 (noting that "classical contracts" suffice for transactions with no significant contractual hazards).

²⁰. Williamson, supra note 8, at 315.

²¹. WILLIAMSON, supra note 6, at 47, 49.
party to a transaction.\(^{22}\) The concept of "principal-agent" is typically used to analyze this problem of self-interest. The prototypical principle-agent problem involves the difficulty that one actor (the principal) will have in getting another actor (the agent) to work on the first party's behalf. A principal can reduce measurement costs to the extent that it can use financial or other incentives to align the self-interest of the agent with its own interests.\(^{23}\)

Second, the parties operate under "bounded rationality"; that is, the parties are subject to significant time, resource, and cognitive restraints that limit their capacity to choose an optimal outcome.\(^{24}\) Thus, although economic actors ideally would identify and negotiate every possible contingency to a transaction, "[c]omprehensive contracting is not a realistic organizational alternative when provision for bounded rationality is made."\(^{25}\) When contracts are incomplete, the parties find themselves in a continual process of negotiation as they attempt to adjust their actions and agreement in response to changes in circumstances,\(^{26}\) which create what Williamson calls "governance" costs.\(^{27}\)

In light of the previous potential costs, economic actors will choose institutional arrangements, which Williamson calls "governance structures,"\(^{28}\) that minimize their transaction costs. Assuming that internal organization involves the same production costs as hybrid contracting, a firm will choose internal organization to produce goods or services when this arrangement has lower transaction costs than using hybrid contracting.

Third, the cost of contracting for the production of a good or service is related to whether a transaction involves "asset specificity," or the development of resources that are specific or idiosyncratic to a transaction.\(^{29}\) Because it will be costly for the actor that owns such an asset to reconfigure it for other purposes, asset specificity gives an

\(^{22}\) Id. at 29.

\(^{23}\) See BUTLER, supra note 13, at 740–41 (describing the literature on agency costs as it applies to shareholder control of modern corporations).

\(^{24}\) See WILLIAMSON, supra note 6, at 45–46 (defining "bounded rationality").

\(^{25}\) Id. at 46 (citation omitted).

\(^{26}\) Id. at 21.

\(^{27}\) Id. at 29.

\(^{28}\) Id. at 21. As Williamson states, "[t]ransaction costs are economized by assigning transactions (which differ in their attributes) to governance structures (the adaptive capacities and associated costs of which differ) in a discriminating way." Id. at 18.

\(^{29}\) Id. at 52–54.
advantage to the other party to the bargain. For example, if a firm builds a plant next to the buyer of its output, the buyer may reduce the price it is willing to pay with the knowledge that it is costly for the seller to find alternative customers. Because of this "hold-up" problem, a firm may find that no one will contract with it and that it will have to make the product or service itself.\textsuperscript{30}

To sum up, transaction cost economics is focused on explaining the form in which economic transactions take place. A firm will adopt the institutional arrangement ("governance structure") that it believes will minimize its transaction costs. Transaction costs are a function of (1) incomplete contracts, which occur because of bounded rationality; (2) opportunistic behavior, which occurs because of self-interest; and (3) hold-up problems, which occur because of asset specificity.

II. POLITICAL INSTITUTIONS

The form of economic institutions reflects the transaction costs of collective action between economic actors. Similarly, the form of political institutions is related to the transaction costs of collective action between political actors. Despite this parallelism, the study of "political" transaction costs is relatively new.\textsuperscript{31} This Part draws on the incipient literature on political transaction costs and expands it to include government regulation. Specifically, I explore three aspects of political institutions. I first explain why political actors and economic actors both confront similar problems of collective action, and why the problems are of a greater magnitude in the governmental context. I then briefly consider the collective action problems that voters and members of Congress must overcome, which presents some concepts that I draw on in the remainder of the Essay. I then focus on the collective action problems that agencies confront in implementing government regulation. In doing so, I propose a typology of private involvement in government regulation, which reveals that agencies confront a type of make-or-buy decision that is similar to the one that involves private actors, and discuss why these make-or-buy decisions are a function of the same properties—incomplete contracts, opportunistic behavior, and hold-up problems—that affect private

\textsuperscript{30} Id. at 52–56.

\textsuperscript{31} See JAMES Q. WILSON, BUREAUCRACY: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT 358 (1989) ("The idea of transaction costs has not been applied, so far as I know, to government activities.").
transactions. Finally, I propose that transaction cost analysis offers a useful normative framework to evaluate whether outsourcing government regulation is appropriate.

A. Collective Action Problems

Like economic actors, political actors confront commitment and enforcement problems, and, like economic institutions, political institutions are designed to mitigate these problems. According to Professor Douglass North, "political institutions constitute ex ante agreements about cooperation among politicians. They reduce uncertainty by creating a stable structure of exchange."32

The problems of collective action, however, are more daunting for political actors than for economic actors. Measurement and enforcement costs are far higher in political settings because "[i]t is extraordinarily difficult to measure what is being exchanged in political markets and in consequence to enforce agreements."33 North explains:

After all the basic separation between polity and economy has always, even amongst the most confirmed libertarians, left a residual of activities to be undertaken by government because of the inherent difficulty that arose from the public good attributes, free riding and costly information of certain types of activity.... Those that can be readily handled by individual or small group bargaining don’t need to be placed on the public agenda.... Thus the selection process is one in which the high transaction cost issues gravitate to the polity.34

The magnitude of transaction costs in political settings has an important ramification for normative evaluations of different institutional arrangements. An existing structure should not be condemned for its inefficiency unless a superior alternative exists in light of the transaction cost problems. In the government context, "[m]any apparently inefficient outcomes can in fact be understood as consequences of constraints imposed by various transaction costs, or as creditable attempts to cope with them."35 Put another way, just

33. Id. at 362.
34. Id. at 361–62.
35. DIXIT, supra note 12, at 146.
because government institutions appear to be inefficient does not necessarily mean that more efficient alternative arrangements exist.

Williamson goes further. He would apply a presumption of efficiency to existing modes of government organization. He acknowledges that "some may believe that an extant mode enjoys an undeserved advantage by this presumption," but the fact that "an extant mode has survived a comparative institutional competition" is a "rough and ready" test of efficiency. To rebut the presumption, the analyst must show that a particular institutional arrangement arose from some "unacceptable initial condition," such as "conceptual error" or "pathology." Thus, the fact that most regulatory activities are still done by government employees suggests that this institutional arrangement is the most efficient form of establishing and enforcing regulatory standards. As will be seen, transaction costs analysis confirms this general conclusion.

B. Congress

In a representative democracy, there are several layers of collective action problems, all of which create transaction costs. This Section briefly considers those problems faced by voters and members of Congress, and the next Section considers the collective action problems that regulatory agencies confront.

Voters choose their elected representatives, which is a principal-agency problem that creates high measurement costs for voters. In turn, legislators must bargain with other legislators to provide benefits to their constituents, a process that is hampered by bounded rationality and the potential that legislators will renege on the commitments they make to secure political deals. In designing laws, Congress tries to ensure that the agencies that implement the legislation fulfill legislative preferences, which is a principal-agent problem that presents measurement and governance costs.

36. See Williamson, supra note 8, at 316 (arguing that existing modes of organization should be presumed to be efficient unless a superior feasible alternative can be described and implemented).
37. Id. at 316.
38. Id. at 317.
As observers of government regulation well know, Congress delegates broad policy discretion in some areas, but not others. Professors David Epstein and Sharyn O'Halloran observe that this decision is similar to the make-or-buy decision that economic actors confront. They explain, "[w]hen making public policy the basic choice is between production within Congress or delegation to the executive; the details of policy either will be spelled out in legislation or will be left for the executive branch to determine." Epstein and O'Halloran contend:

Just as transaction cost economics assumes that governance structures will be chosen so as to minimize the transaction costs associated with economic exchange, so political governance structures should minimize the political transaction costs associated with the implementation of a given policy where, again, these costs should be assessed from legislators' reelection perspective.

Delegation of substantial discretion to an agency, however, creates the political equivalent of the "hold-up" problem identified earlier. Because of bounded rationality and uncertainty, Congress may not be able to specify the details of all future actions, yet it is stuck with the discretion it has delegated to an agency. Using Epstein's and O'Halloran's terminology, the legislative delegation will be an incomplete contract. This suggests that Congress's willingness to delegate significant policymaking authority to an agency will depend on the degree of oversight and monitoring problems that may exist.

40. DAVID EPSTEIN & SHARYN O'HALLORAN, DELEGATING POWERS: A TRANSACTION COST POLITICS APPROACH TO POLICY MAKING UNDER SEPARATE POWERS 46 (1999). Congress has the choice of a number of governance structures it can use to condition its delegation of power to the executive branch, "including sunset provisions, reporting and rule-making requirements, exemptions, and compensations for affected parties." Id.

41. Id. at 46–47.

42. See supra note 30 and accompanying text.

43. EPSTEIN AND O'HALLORAN, supra note 40, at 48 (observing that "potential executive abuse of discretionary authority is the political equivalent of the hold-up problem").

44. Id. at 48. Moreover, agencies lack legal authority to make a binding commitment not to abuse discretionary authority because there are no legal means for current agency officials (or the president) to bind the actions of future agency officials. Id.

45. Id. One conventional rationalization for vague delegations is that Congress lacks either the technical expertise or the political will to write more specific legislation, Peter H. Aranson et al., A Theory of Legislative Delegation, 68 CORNELL L. REV. 1, 21–24 (1982), but there are numerous examples of where it overcomes both of these factors. See Sidney A. Shapiro & Robert L. Glicksman, Congress, the Supreme Court, and the Quiet Revolution in Administrative
C. Agencies

Just as Congress establishes a set of institutional arrangements between it and agencies that reflect transaction costs, every agency must determine the type of institutional arrangements on which it will rely to implement its legislative mandate. In the congressional setting, legislators are expected to choose institutional arrangements that minimize the costs of achieving their objective, which in the economic analysis of politics is usually assumed to be reelection.46 What about agency officials? If members of Congress seek to maximize their political efficiency in terms of reelection possibilities, what do agency officials seek to maximize?

The conventional assumption in economic models is that public officials have their own interests in money, security, status, and policy that may or may not align with the interests of Congress.47 This is the root of the principle-agent problem between Congress and agencies discussed in Section B. The literature describes this problem as "bureaucratic drift," or the potential that an agency will adopt outcomes different from the policies preferred by Congress when it originally delegated power.48 Nevertheless, public officials do not always act in this manner,49 and the extent of bureaucratic drift is unknown.

For present purposes, I assume that agency officials will adopt institutional arrangements that promote legislative goals at the lowest transaction cost. I do this because I want to test when it is advisable to involve private parties in the implementation of regulation according to transaction cost analysis.50 Under this approach, reliance on private

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46. See, e.g., Weingast & Marshall, supra note 39, at 137 (basing transaction cost analysis on legislators' pursuit of the goal of reelection).
47. Terry M. Moe, Politics and the Theory of Organization, 7 J.L. ECON. & ORG. 106, 125 (Special Issue).
49. See, e.g., STEVEN KELMAN, MAKING PUBLIC POLICY: A HOPEFUL VIEW OF AMERICAN GOVERNMENT 251–54, 266 (1987) ("[T]he more important a policy is, the less important is the role of self-interest in determining that policy."); Steven P. Croley, Theories of Regulation: Incorporating the Administrative Process, 98 COLUM. L. REV. 1, 65–67 (1998). Croley notes that "regulatory outcomes ameliorate market failures and vindicate the citizenry's interests ... more commonly than other scholars of regulation acknowledge." Id. at 66.
50. I am also assuming that the agency is implementing a legitimate public policy program. I assume away the principal-agency problems between voters and legislators, because my focus
parties in apparently inappropriate circumstances suggests bureaucratic drift because agencies have not chosen the best institutional approach for regulation.

I now turn to identifying how transaction cost analysis would assist an administrator who seeks to determine in good faith when it is advisable to involve private parties in the implementation of regulation. I first identify a typology of government-private relationships, then suggest how these choices constitute the same type of make-or-buy decision that economic actors confront, and finally discuss how transaction costs are a function of the same properties that affect economic transactions.

1. Typology. Table 1 recognizes two policy-related functions: the choice of regulatory standards and the enforcement of such standards. It also recognizes that the government can be wholly responsible for the development and enforcement of regulatory standards, or it can involve private parties in these functions. Under the traditional model (cell I), an agency writes a regulatory standard and adopts it using notice and comment rulemaking. The agency then enforces the regulation by adjudicating violations and determining remedies. Alternatively, an agency can rely on private entities to write regulatory standards that the agency ultimately adopts (cell II), with or without changes, using notice and comment rulemaking. The agency, however, relies on government employees to enforce that regulatory standard. Or the agency can employ private parties to enforce its regulations or negotiate with regulated entities over the scope of compliance (cell III). In this category, government employees are responsible for writing the standards that are being enforced. Finally, an agency can rely on industry self-regulation (cell IV), which involves private actors in both writing standards and in enforcing those standards, subject to oversight by the agency. The last three categories, in different ways and to varying degrees, involve using private entities to originate and enforce government regulation, as the following examples illustrate.\footnote{Some of these examples are discussed in Freeman, supra note 5, at 636–64.}

\begin{table}
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Cell} & \textbf{Regulatory Standard} \\
\hline
I & Agency writes and adopts regulatory standard using notice and comment rulemaking. \\
II & Agency relies on private entities to write regulatory standards, which are ultimately adopted. \\
III & Agency employs private parties to enforce regulations or negotiate scope of compliance. \\
IV & Industry self-regulates, with oversight by the agency. \\
\hline
\end{tabular}
\caption{Typology of Government-Private Relationships.}
\end{table}
TABLE 1
MODELS OF REGULATION

<table>
<thead>
<tr>
<th>Enforcement</th>
<th>Standard Setting</th>
</tr>
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<tbody>
<tr>
<td>Governmental</td>
<td>I. Governmental Traditional Agency Model</td>
</tr>
<tr>
<td>Governmental</td>
<td>II. Governmental Contractual Standard Setting</td>
</tr>
<tr>
<td>Private</td>
<td>III. Private Contractual Enforcement</td>
</tr>
<tr>
<td>Private</td>
<td>IV. Private Self-Regulation</td>
</tr>
</tbody>
</table>

First, private parties are greatly involved in the creation of government regulation. There are numerous private organizations that generate thousands of industrial codes and products standards, and agencies incorporate these national consensus standards by reference. For example, when the Occupational Safety and Health Administration (OSHA) adopted 428 new protective health standards in 1988, most of the new regulations were adoptions of national consensus standards written by the American Conference of Governmental and Industrial Hygienists (ACGIH). The National Technology Transfer and Advancement Act requires federal agencies to use voluntary consensus standards where appropriate and when they will not conflict with applicable law, and to participate in the development of such standards when such participation is consistent with the agency's mission. The Securities and Exchange

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52. Id. at 639–40.
53. Air Contaminants, 54 Fed. Reg. 2332 (Jan. 19, 1989) (codified at 29 C.F.R. § 1910.1000 (2003)). In AFL-CIO v. OSHA, 965 F.2d 962 (11th Cir. 1992), the court remanded the regulations to OSHA because it had failed to provide a sufficient explanation for their adoption, id. at 986–87, and the regulation was not readopted.
Commission (SEC) requires that financial statements be prepared in accordance with accounting principles that have substantial authoritative support, and until recently the agency relied on contractual standard setting by private accounting associations to produce such standards. In regulatory negotiation, an agency depends on negotiations between private entities, who represent the entities that will be regulated and the beneficiaries of the protective standard, to write a regulatory standard.

Second, just as private parties are involved in setting the standards for government regulation, they are also involved in determining the outcome of the enforcement proceeding in two ways. On the one hand, an agency may actually hire private entities to conduct inspections or adjudications. The FAA's reliance on private actors to maintain airport security, mentioned earlier, is an example of this arrangement. So is the use of private insurance companies by the Department of Health and Human Services (HHS) to screen Medicare and Medicaid reimbursement claims from medical providers. The California workplace safety and health agency, Cal-OSHA, delegated enforcement of safety standards at worksites to a committee of union and employer representatives. On the other hand, the government negotiates with private entities over the enforcement of standards. It is common for agencies to settle an enforcement action by reducing the penalty that is imposed in return for the company's agreement to comply with the regulation it has

56. See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work), 36 Conn. L. Rev. 915, 919 (2003) ("Stripped of power to make authoritative auditing standards is the American Institute of Certified Public Accountants ('AICPA'), the industry body having since 1939 defined Generally Accepted Auditing Standards ('GAAS')."). Under the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified at 15 U.S.C. § 7201), the SEC can still rely on contractual standard setting but Congress established qualifications that private actors must meet and it subjected them to new oversight. See infra notes 77-78 and accompanying text.

57. See Philip J. Harter, Assessing the Assessors: The Actual Performance of Negotiated Rulemaking, 9 N.Y.U. Envtl. L.J. 32, 32 (2000) ("Negotiated rulemaking is a process by which representatives of the interests that would be substantially affected by a proposed rule negotiate to reach a consensus.").

58. See supra note 2 and accompanying text.

59. Robert A. Berenson & Dean M. Harris, Using Managed Care Tools in Traditional Medicare—Should We? Could We?, 65 Law & Contemp. Probs. 139, 146 (Autumn 2002).

Enforcement negotiations, however, can result in outcomes different than that achieved through adjudication or the settlement process. OSHA, for example, may settle an enforcement case if the employer will agree to undertake additional compliance efforts at plants other than the one that the agency inspected, even though OSHA has not found those other plants to be in violation. Similarly, the EPA negotiates supplemental environmental agreements that allow a regulated entity to avoid a traditional civil or criminal penalty by agreeing to implement affirmative protection measures, such as pollution prevention programs, not required by agency regulations.

Finally, some self-regulation occurs in the absence of government regulation. Such self-regulation often represents an effort to head off the adoption of regulatory legislation. For example, the Bush administration has chosen voluntary measures to control greenhouse gases responsible for global climate change in lieu of mandatory controls. Because I am discussing make-or-buy decisions, however, this category involves self-regulation that occurs under the auspices of an agency that oversees it. For example, although the Health Care Finance Administration (HCFA) has regulatory authority to accredit hospitals for participation in Medicare and Medicaid, it defers to the standard setting and enforcement activities of the private Joint Commission on Health Care and Accreditation of Health Organizations (JCAHO). Similarly, the SEC relies on self-regulation by the stock exchanges. The two major stock exchanges, smaller regional exchanges, and the over-the-counter markets are all

61. See, e.g., OCCUPATIONAL SAFETY & HEALTH LAW 316 (Stephen A. Bokat & Horace A. Thompson III eds., 1988) ("[T]he Secretary [of Labor] has been extremely willing to negotiate significant reductions in the amount of the proposed penalties provided there is assurance of abatement.").


65. Freeman, supra note 5, at 610–12.
engaged in self-regulation under the regulatory supervision of the Securities and Exchange Commission.66

2. Transaction Cost Analysis. As the previous examples indicated, a regulatory agency can rely solely on its own employees to write and enforce regulatory standards, or it can involve private parties in these functions. In deciding which form of collective action to pursue, an agency makes a make-or-buy decision. Under the traditional agency model, the government relies on internal organization to make its own "goods" (regulatory standards) and "services" (regulatory enforcement). Alternatively, the agency can use one of the other three options, all of which involve hybrid "contracting" for these same goods and services. The relationship between an agency and private actors in these other options may not involve an actual contract to "buy" a good or service, although it can. Nevertheless, as Professor Jody Freeman indicates, the word "contract" is a useful metaphor because it captures the give-and-take relationship between the agency and private parties, and it usefully distinguishes internal and external production of government goods and services.67 I therefore describe agency use of privately developed standards (cell II) as "contractual" standard setting, and agency involvement of private actors in deciding levels of compliance as "contractual" enforcement.

As Parts III and IV more fully develop, an agency's reliance on private parties creates several important transaction costs for the agency. Whether the agency's goals will be met is affected by a private actor's opportunistic behavior, fueled by its self-interest. If the private entity is an economic actor (or if it is subject to the control of economic actors), it will resolve policy issues in a manner that maximizes its profit (or the profit of those who control it). Such actions may be inconsistent with the agency's goals established in its

66. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 10.2, at 458 (3d ed. 1996). Likewise, "[a]lthough the Commission has ... the direct authority to regulate broker-dealers who are members of the [National Association of Securities Dealers], as a practical matter the bulk of the day-to-day regulation is generally delegated to the self regulatory organization." Id. at 466–67.

67. Jody Freeman, Extending Public Law Norms Through Privatization, 116 HARV. L. REV. 1285, 1288 (2003). Whereas internal production is based on hierarchical relationships, which is how agencies (like private firms) manage their own employees, the involvement of private parties in regulation is a "set of negotiated relationships" that are "dynamic, nonhierarchical, and decentralized, envisioning give and take among public and private actors." Freeman, supra note 5, at 571.
statutory mandate. If the private actor is a nonprofit group, it may resolve policy issues in a manner that it deems appropriate in terms of its own objectives, but this resolution may also be inconsistent with the agency’s goals established in its statutory mandate. The possibility of opportunistic behavior therefore increases the measurement costs of the government agency.

Moreover, any “contract” between an agency and private entities may be incomplete because of bounded rationality, which creates governance costs. When the transaction takes place under conditions of uncertainty, the private actor may be able to exploit an information advantage to take actions that are in its self-interest, but not in the agency’s self-interest, which again raises the agency’s measurement costs.

Finally, the agency may be subject to a hold-up problem similar to the one identified by Epstein and O’Halloran. Once an agency involves a private actor in making policy decisions, it may not be easy for that agency to take back the responsibility for making such decisions. For example, private actors may have the political power to defend their participation in making regulatory decisions. This security may encourage them to exploit their self-interest in ways that are detrimental to the goals of the agency.

Thus, the agency’s cost of addressing potential opportunistic behavior by a private actor is a function of the extent to which the private actor’s interests originally are aligned with the agency’s interests and the extent to which the agency can create incentives to align its interests and the interests of the private actor. In the commercial context, economic actors can establish contract terms, such as bonuses tied to performance, which align their interests with their agent’s interests. As Parts III through V explore, agencies may or may not have the same option.

3. Make-or-buy? The advantage of transaction cost analysis in this context is that it offers a framework for evaluating when outsourcing government regulation is appropriate. Although relying on private actors can save the government money, this choice can also increase the government’s transaction costs when a transaction involves significant opportunistic behavior, incomplete contracting, and hold-up problems. An agency should rely on its own employees

68. See supra note 40 and accompanying text.
when the transaction costs of relying on private parties makes outsourcing more expensive.

More broadly, this framework suggests when reliance on private actors is less likely to produce effective outcomes from the agency's point of view. When the agency confronts opportunistic behavior, incomplete contracting, and hold-up problems, reliance on private actors increases the risk that a transaction will not produce the outcome desired by the agency. Thus, these properties indicate when outsourcing may be inappropriate and when an agency should be skeptical that outsourcing may be to the public's advantage.

### III. Contractual Standard Setting

Contractual standard setting is one of the three ways that agencies can outsource regulation according to the typology identified in Part II. In contractual standard setting, an agency relies on private actors to write the regulatory standards that it ultimately adopts. The agency reduces its transaction costs by relying on outside parties, but it must compare this cost savings with the additional transaction costs that contractual standard setting will entail. The agency's transaction costs are related to opportunism, incomplete contracts, and hold-up problems. These costs often vary depending on whether the agency is relying on private standard-setting organizations or whether it is engaged in regulatory negotiation.

#### A. Private Standard-Setting Organizations

Reliance on private standard-setting organizations does not appear to be justified for most types of regulatory standards. First, the private actors are likely to engage in opportunistic behavior because their goals do not correspond with the agency's goals. Second, any transaction between an agency and a private standard-setting organization is likely to be incomplete because bounded rationality makes it difficult for an agency to specify in advance the parameters of the regulatory standard. Finally, reliance on private standard-setting organizations creates a hold-up problem. In light of these potential problems, an agency's reliance on private standard setting suggests bureaucratic drift.

1. **Opportunistic Behavior.** An agency's reliance on private actors to write regulatory standards creates agency problems. The incentives of the private actors who create the standards may be
different than the incentives of agency officials who are attempting to implement their statutory mandate in good faith. Private actors will seek to resolve policy issues in a manner that maximizes their own profit. If the private actor is nonprofit, its incentives may still be inconsistent with the agency's objectives, either because the group has a different set of goals than the agency or because it is heavily influenced by profit-maximizing private firms.

Private actors may have different goals than a regulatory agency. For example, Congress has authorized agencies like the EPA to act on the basis of the best available evidence to protect individuals and the environment before harm occurs. By comparison, a private organization may look to scientific norms to write protective standards. These norms may require waiting until there is additional scientific evidence before any conclusion is reached concerning the risk posed by a chemical or other hazard.

Moreover, industry representatives tend to dominate decisionmaking in many nonprofit organizations, and the standards that are produced tend to reflect the self-interest of the corporations for whom the participants work. The lack of non-industry representatives leads private standard-setting organizations to strike a different balance between cost and protection than that favored by non-industry actors. As Professor Robert Hamilton has explained:

Because [of] the... industry orientation of most technical committees, the costs and complexity of increased safety or purity will almost certainly be weighted more heavily by these committees than by an individual whose primary concern is safety or health...

The welter of legislative enactments vesting issues of safety or health

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70. See Kathleen Patchel, Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code, 78 MINN. L. REV. 83, 124 (1993) (finding that “certain interest groups seem consistently to get their way at the expense of others” in the UCC drafting process, and that the history of Article IV demonstrates that, in particular, banks “consistently win out at the expense of their customers”); Robert E. Scott, The Politics of Article 9, 80 VA. L. REV. 1783, 1809, 1850–51 (1994) (finding impressionistic and empirical evidence that the private legislative bodies that drafted Article 9 of the UCC tended to favor the interests of asset-based financiers over consumer interests). See generally Robert W. Hamilton, The Role of Nongovernmental Standards in the Development of Mandatory Federal Standards Affecting Safety or Health, 56 TEX. L. REV. 1329, 1380–83 (1978) (concluding that three groups—small business, labor, and consumers—are not adequately represented in private organizations that write nongovernmental standards affecting safety and health).
in the governmental agencies suggests that for most people the balance provided by the private sector often fails to accommodate health or safety considerations satisfactorily.71

Private parties will be able more easily to exploit their self-interest to the extent that there is asymmetrical information. An agency may wish to employ a private entity to write a protective standard because it has lower cost access to specialized information than does the agency. The existence of asymmetrical information, however, also invites opportunistic behavior by the private entity, which can seek to exploit its superior access to the information to serve its own self-interest. In such circumstances, the agency must hire its own experts to review the work of the private entity. This last step may make it as or more expensive to “hire” a private entity to produce a standard than for the agency to produce the standard internally.

One does not have to look very far to find evidence of self-interest at work in the private generation of regulatory standards. For example, OSHA’s adoption of protective health standards written by the ACGIH was noted earlier.72 Professors McGarity and I have found that these standards provide limited protection for workers in many cases, because industry-dominated committees are more reluctant than OSHA to characterize a substance as a carcinogen, and less likely to rely on published scientific data instead of industry-supplied information.73 “When standards set by private organizations are perceived as having regulatory implications, consensus becomes harder to reach,”74 as regulated entities attempt to influence the organization to take positions favorable to them.

In securities regulation, Congress recently addressed the role played by self-interest in the generation of accounting standards. Earlier it was noted that the SEC generally relied on the accounting industry to produce the accounting standards that underlie SEC-mandated financial disclosures.75 The SEC had relied on the private American Institute of Certified Public Accountants, a trade

71. See Hamilton, supra note 70, at 1378.
72. See supra note 53 and accompanying text.
75. See supra note 56 and accompanying text.
association of financial auditors, and on the Financial Accounting Standards Board (FASB), both funded by the accounting industry, for these functions. The new Sarbanes-Oxley Act breaks this link between the industry and private standard setting, and it subjects private standard setting to control by the Public Company Accounting Oversight Board (PCAOB), as well as the SEC.

The addition of the PCAOB addresses the problem of asymmetrical information, because it places an independent entity, with the necessary expertise to review auditing and accounting standards, in between the SEC and the adoption of industry-generated standards.

2. Incomplete Contracting. An agency's transaction costs are increased to the extent that private actors behave opportunistically in writing regulatory standards. The agency's transaction costs are also a function of the incomplete nature of the transaction between it and the private actors. Like private actors, public officials operate under bounded rationality, which also means there is a type of "incomplete" contract between the agency and the private actors to whom the agency looks to write a regulatory standard. From the agency's perspective, the problem is in adequately specifying the goals or parameters of the regulatory protections that the agency is seeking. As students of regulation know, determining the appropriate level of

76. See Cunningham, supra note 56, at 919 (outlining Sarbanes-Oxley's impact on these organizations).


78. 15 U.S.C.A. § 7211(c)(2). PCAOB shall "establish or adopt, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers." Id. The PCAOB is a nonprofit private corporation, consisting of five members, only two of who can be CPAs. 15 U.S.C.A. § 7211(e)(1)–(2). If one of the two CPA members is chair, the person cannot have been a practicing CPA for at least five years prior to the person's appointment to the PCAOB. 15 U.S.C.A. § 7211(e)(2). The PCAOB is funded by assessments paid by securities firms. 15 U.S.C.A. § 7219(d)(2). In adopting audit standards, the PCAOB may rely on the recommendations of advisory groups or contractual standard setting organizations, but it may rely on the latter only to the extent that they meet certain conditions. These include that the group is not funded by the accounting industry and is controlled by a board of trustees that consists of a majority of persons who have not been employed by public accounting firms within two years of their appointment as a trustee. 15 U.S.C.A. § 77s(b)(1). All standards adopted by the PCAOB are subject to review by the SEC, which has the authority to amend or replace them. 15 U.S.C.A. § 7217(a)–(b). Further, Congress permitted the SEC to rely on privately generated, general accounting principles by the FASB or some other group, but only if it meets the same conditions concerning financial support and the board of trustees that apply to contractual standard setting entities on which the PCAOB might rely. 15 U.S.C.A. § 77s(b)(1).
regulation and how best to achieve it can require making decisions on
the basis of incomplete information and the resolution of difficult
value conflicts. Moreover, the reconciliation of value conflicts is not
limited to health, safety, and environment regulation because society
has regulatory goals other than economic efficiency even in
commercial contexts.

In these circumstances, the privately developed standard is
unlikely to capture the resolution of information defects and value
conflicts that the agency intended, which will require the agency to
rewrite the standard or even to withdraw it, resulting in higher
transaction costs for the agency than if it had written a proposed rule
itself. The agency is more likely to avoid these costs if it is proposing
to adopt technical standards that do not involve the type of
information defects and value conflicts that make more policy-
oriented rules controversial.

Agencies can work with contractual standard-setting
organizations in the development of regulatory standards, a strategy
that increases the agency's governance costs, but not as much as if the
agency is forced to rewrite a privately proposed standard in a
substantial manner in the rulemaking process. Indeed, Congress has
ordered agencies to engage in such participation under appropriate
circumstances.

3. Hold-Up Problems. Besides incomplete contracts and
opportunism, agency use of privately written regulatory standards
presents one additional problem: it creates an equivalent of
Congress's hold-up problem identified above. As noted earlier in
Section II.B, Congress may be reluctant to delegate policy discretion
to agencies because Congress may lack effective means to control the
outcome of the decisions that are reached once the delegation

79. See SIDNEY A. SHAPIRO & ROBERT L. GLICKSMAN, RISK REGULATION AT RISK:
RESTORING A PRAGMATIC APPROACH 20–24 (2003) (discussing bounded rationality and the
need to reconcile conflicting values in the context of protecting individuals and the
environment).
(proposing that commercial regulation can involve noneconomic goals such as "fairness").
81. See id. at 348–49 (arguing that current safeguards fail to protect noneconomic goals in
contractual standard-setting situations).
82. See supra notes 54–55 and accompanying text.
occurs. When an agency establishes a pattern and practice of relying on privately generated standards, as the SEC did with the accounting industry, the agency may likewise find it difficult to modify or reject those standards when it is advisable to do so.

An agency may find itself in this situation for two reasons. First, the reliance on privately generated standards frees an agency from developing the extensive expertise that is necessary to write standards itself. At the same time, this may mean that the agency lacks the expertise to oversee the standards-writing process in an effective manner. Second, to the extent that a politically powerful industry supports private standard setting, the agency may find it politically difficult to engage in extensive rewriting of private standards, although it has the legal capacity to do so. The more financially valuable it is for an industry, like the accounting industry, to defend the standards that they write, the more money they will invest in political donations, lobbying, and legal strategies to protect their interests.

In these situations, it may be more difficult for the agency to assert its authority to change or to modify privately generated standards than to have relied on internal production of regulatory standards in the first place. Thus, when an agency is likely to find itself in this situation, internal standard setting is advisable and the agency should develop the expertise to write its own standards.

B. Regulatory Negotiation

As compared to private standard setting, regulatory negotiation is less vulnerable to opportunistic behavior. Nevertheless, regulatory negotiation may not be advisable because of incomplete contracting, and an agency may also have a type of hold-up problem if it employs it. Still, on balance, this approach presents fewer transaction cost problems than private generated standards.

1. Opportunistic Behavior. An agency's reliance on private actors to write regulatory standards invites opportunistic behavior on their part. In this regard, regulatory negotiation is a distinct improvement. Whereas decisionmaking in private standard-setting organizations tends to reflect negotiations among corporate interests, a regulatory negotiation involves the participation of representatives

83. See supra note 45 and accompanying text.
from all affected interests.\textsuperscript{84} While each participant may have its own self-interest, the result of the regulatory negotiation will not be as one-sided as private standard setting, because regulation negotiation employs a consensus decisionmaking rule.\textsuperscript{85}

2. \textit{Incomplete Contracting}. Agencies nevertheless may find it difficult to rely on regulatory negotiation to establish certain types of regulatory standards because of the difficulty of specifying in advance a set of policy parameters that will lead to the resolution of information deficiencies and value conflicts in a manner acceptable to the agency. Thus, an agency should not use regulatory negotiation in situations where the negotiation may produce a result that is outside of the policy parameters that the agency considers reasonable. If the agency cannot specify these parameters with reasonable specificity, the agency may have to reject the results of the regulatory negotiation. The Administrative Conference acknowledged this difficulty when it warned that only certain types of regulatory issues are suitable for regulatory negotiation.\textsuperscript{86}

3. \textit{Hold-Up Problems}. Regulatory negotiation also presents a type of hold-up problem. Once an agency charters a regulatory negotiation, it is not completely free to disregard the results for two reasons. First, the members of the group may be able to bring political pressure on the agency to adopt the rule. Second, if the agency does refuse to adopt the rule, or significant parts of it, it is likely to discourage the participation of private parties in future regulatory negotiations, because they will be concerned that they are wasting their time. In other words, the private parties will seek to protect their specialized assets (the results of the regulatory negotiation) through political pressure, or they will be reluctant to devote time to a regulatory negotiation because it creates a specialized asset that cannot be used for other purposes.

The degree to which this is a problem is hard to determine. In a well-known case study of a regulatory negotiation at the EPA that

\begin{itemize}
\item \textsuperscript{84} See \textit{supra} note 57 and accompanying text.
\item \textsuperscript{86} See ACUS Recommendation 82-4, 1 C.F.R. § 305.82-4 (1995) (not included in C.F.R. after 1995), reprinted in \textit{Admin. Conference of the United States, Negotiated Rulemaking Sourcebook} 12 (1995) (identifying the conditions under which regulatory negotiation is more likely to be successful).
\end{itemize}
resulted in a regulatory standard for wood stoves, Professor Bill Funk found the negotiation led to a result that was not authorized by statute, but the EPA adopted the standard nevertheless. Proponents of the process find this concern to be overstated, because a court can also strike down a regulation if it is not authorized by the agency’s mandate. Of course, as Funk notes, if the regulatory negotiation truly succeeds, no one will challenge the rule because all of the interested actors were represented in the negotiation and approved of the result. Moreover, the problem only exists to the extent that regulatory negotiation produces an unacceptable rule that the agency nevertheless cannot reject. Agencies can avoid this result by participating in the regulatory negotiation and by choosing negotiators who steer the participants into an agreement that falls within the policy parameters that the agency is willing to accept.

Bounded rationality and the hold-up problem may help to explain why agencies have made relatively limited use of regulatory negotiation, although it is unclear what proportion of regulatory issues may or may not be suitable for regulatory negotiation because of these problems. Nevertheless, internal production of regulatory standards can be the preferred option. Therefore, rational action requires a comparison of the transaction costs of each option.

87. William Funk, When Smoke Gets in Your Eyes: Regulatory Negotiations and the Public Interest—EPA’s Woodstove Standards, 18 ENVTL. L. 55, 66-78 (1987) (concluding that the draft rule proposed by regulatory negotiation and adopted by the EPA as proposed was of dubious legality).

88. See, e.g., Phillip J. Harter, The Role of Courts in Regulatory Negotiation—A Response to Judge Wald, 11 COLUM. J. ENVTL. L. 51, 62 (1986) (“Were it not for judicial oversight, it would surely not be inconceivable for the negotiating parties to make impermissible ‘deals’ that are outside Congress’s contemplation.”).

89. See Funk, supra note 87, at 94 (“Discretion delegated to the agency by Congress is effectively exercised by the group of interested parties, constrained only by the need to obtain consensus.”).

90. Some observers suggest that agencies fail to use regulatory negotiation because it is not more efficient than traditional rulemaking, but other analysts deny this claim. Compare Cary Coglianese, Assessing the Advocacy of Negotiated Rulemaking: A Response to Phillip Harter, 9 N.Y.U. ENVTL. L.J. 386, 447 (2001) (asserting that regulation negotiation “demands a concentrated investment of time and resources by all involved, but without any clear corresponding return in terms of avoiding litigation or achieving other goals”), with Jody Freeman & Laura I. Langbein, Regulatory Negotiation and the Legitimacy Benefit, 9 N.Y.U. ENVTL. L.J. 60, 62 (2001) (concluding that studies “tend, on balance, to undermine arguments made by the critics of regulatory negotiation and to bolster the claims of proponents”). If regulatory negotiation is more efficient, the reasons suggested in the text are more plausible explanations of why agencies do not use this process more.
IV. CONTRACTUAL ENFORCEMENT

According to the typology set forth in Part II, contractual standard setting is one of the three ways that agencies can outsource regulation. Agencies can also involve private parties in the enforcement of regulatory standards after they are adopted. There are two types of contractual enforcement relationships between an agency and private actors. First, the agency can hire private actors to enforce its regulatory standards in lieu of relying on government employees. Second, the agency can negotiate with private parties concerning the scope of compliance. While these negotiations can produce the same outcome as traditional enforcement, at times, they can lead to very different outcomes. In either situation, the outcome is the result of an agreement between the agency and a regulated entity that determines the scope of regulatory protection.

A rational administrator will involve private parties if it reduces the agency's transaction costs as compared to the costs of using the traditional model. This Part considers the two methods of involving private actors and the implications of a transaction cost analysis of each. The transaction cost analysis suggests that relying on government employees to enforce agency regulations involves lower costs for an agency, even if private actors have a profit motive to be more efficient than government employees. Additionally, the analysis reveals that it is less expensive for an agency to settle an enforcement action than to litigate it, but this is less true when the negotiated settlement requires a different level or type of compliance than regulations normally require.

A. Hiring Private Actors

When an agency hires private actors to conduct inspections or adjudications, it is substituting private actors for public employees in providing a government service. There is considerable literature on using private entities to provide government services, although its focus is generally on nonregulatory functions, such as contracting for garbage pickup. In these contexts, the government saves money if private firms can provide the same level of service (or better) than government employees, and for less money. In theory, private

91. See supra note 1 and accompanying text.
92. See, e.g., DONAHUE, supra note 1, at 57-58 (discussing the evidence that private firms are more efficient in the provision of services, such as garbage collection).
managers have greater authority and incentive to act efficiently than governmental managers.\textsuperscript{93} Private actors are not constrained by civil service regulations when they hire and fire employees, and they are not bound by other legal and constitutional constraints that raise the cost of providing government services, such as due process. Private actors have a greater incentive to act efficiently because they have a profit motive. Consistent with these factors, academic studies find private companies generally provide governmental services more cheaply than do their governmental counterparts.\textsuperscript{94}

It does not follow, however, that agencies will reduce their transaction costs by hiring private actors to engage in enforcement functions. In fact, it may be more expensive for an agency to use private actors than to use government employees because of opportunistic behavior and incomplete contracting.

1. \textit{Opportunistic Behavior}. In making outsourcing decisions, an administrator, like an economic actor, must consider how a private firm's self-interest may influence its performance, and whether the firm's incentives are sufficiently aligned with the goals of the government agency to ensure competent performance. The problem here, of course, is that profit-seeking private entities may attempt to reduce the quality of their services to make more money, which increases the government's "measurement" costs. Unfortunately, there is no better example of the adverse impact of a private actor's opportunistic behavior than the failure of the airlines to provide adequate security for airports prior to September 11. The FAA had delegated this function to the airlines, which had hired private firms that failed to provide an adequate level of security,\textsuperscript{95} a problem that the FAA had detected but failed to correct before September 11.\textsuperscript{96}

\textsuperscript{93} See \textit{Wilson}, \textit{supra} note 31, at 349 (indicating why agencies are less likely than private firms to operate efficiently in providing services).

\textsuperscript{94} \textit{Id.} at 350 (finding that, "with few exceptions," the evidence indicates that private firms are more efficient than government in providing services).

\textsuperscript{95} See U.S. General Accounting Office, \textit{Aviation Security: Weaknesses in Airport Security and Options for Assigning Screening Responsibilities}, GAO-01-1165T, at 1 (Sept. 21, 2001), \textit{available} at \url{http://www.gao.gov/new.items/d011165t.pdf} (Testimony Before the Subcommittee on Aviation, Committee on Transportation and Infrastructure, House of Representatives) ("[T]esting of screeners shows... long-standing weaknesses—measured by the screeners' abilities to detect threat objects located on passengers or contained in their carry-on luggage—continue to exist.").

\textsuperscript{96} The FAA had proposed a regulation that would have required higher levels of security by the airlines and the security firms they hired, but development of the regulation was bogged
Congress reacted to this potential for opportunism by making airport security a function of governmental employees.77

I have been assuming that that agencies will act in a rational manner to employ private actors, only doing so when it is less costly than relying on government employees. If, however, an agency fails to measure effectively the private firm's performance, it has no assurance that private entities are performing in a manner consistent with the government's objectives. A recent exposé, for example, revealed that mistakes by a private firm hired by the FAA to approve modifications to airplanes apparently led to the crash of a Swissair jet that killed over 250 persons.98 Moreover, lax FAA monitoring of private inspectors is suspected to have played a role in other aircraft accidents.99 Although the FAA has taken additional steps to improve its oversight, GAO still found that the agency has failed to establish "strong oversight and accountability procedures."100 Moreover, according to its critics, the FAA lacks the technical expertise and resources to oversee the projects.101

The decision to employ private firms may also reflect political influences rather than transaction cost analysis.102 For example, the primary motivation of delegating healthcare enforcement responsibilities under Medicare to private interests, including the role of JCAHO mentioned in Part II.C.1, appears to have been a desire to deflect the political opposition of the medical care interests to government regulation, rather than to reduce transaction costs.103

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81. See Stoller, supra note 98.
82. Professor Schwarcz makes this point but assumes for his analysis that private actors are disinterested and have no conflicts of interest. Schwarcz, supra note 80, at 319 n.2, 321 n.10.
use of private actors to accredit education institutions may similarly reflect political motivations. 104

2. Incomplete Contracting. The cost of outsourcing government enforcement activities is in part a function of the degree to which the private actors hired by an agency will engage in opportunistic behavior. However, the cost of outsourcing is also a function of the extent to which such contracting is incomplete—that is, the degree to which the performance of the vendor can be specified in advance. To the extent that contracts are incomplete because of bounded rationality, the agency must pay higher governance costs, because incomplete contracts require subsequent negotiation and adjustment. 105 The literature on outsourcing government services recognizes this distinction when it notes that it is easier to contract for government services in cases where the parameters of a vendor’s performance can be clearly specified in advance. 106 This means it is easier for the government to contract for garbage pickup than for private prisons because the former function does not require discretionary judgments by private employees in circumstances in which it is difficult to specify in advance how the employees should act. The hiring of private entities to conduct inspections or administer adjudications presents the same issue. The government’s monitoring costs will go up to the extent that it is unable to write complete contracts indicating how private employees are to resolve issues that require difficult judgments and the balancing of multiple factors. If an agency fails to engage in such monitoring, it has no assurance that private entities are performing in a manner consistent with the government’s objectives.

Williamson demonstrates the difficulty of contracting for government services involving bounded rationality when he considers whether the government should contract with a private agency to conduct foreign affairs instead of the State Department. 107 As Professor James Q. Wilson indicates, the problem is that “[i]t would

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104. Clark C. Havighurst, Forward: The Place of Private Accrediting Among the Instruments of Government, 57 LAW & CONTEMP. PROBS. 1, 7 (Autumn 1994) (suggesting that educational accreditation is common because the first amendment tradition discourages government from engaging in direct regulation of education).

105. See supra notes 24–27 and accompanying text.

106. See, e.g., Freeman, supra note 67, at 1342–43 (noting that government performance may be preferable when contracts are incomplete because the task is difficult to specify).

be difficult if not impossible to write a contract that specified in advance what the firm... should do in each case, in large part because the government itself does not know."\textsuperscript{108} Williamson concludes: "Such massive incompleteness greatly complicates and even vitiates any effort to privatize foreign affairs."\textsuperscript{109} To ensure that the government's interests are properly implemented, the government would have to be in continuous negotiation with the private contractor, which makes it less expensive to have these activities done within the government in the first place.

The use of private actors for enforcement purposes is neither as simple as contracting for garbage pickup nor as complicated as hiring a private firm to conduct foreign policy on behalf of the United States. Nevertheless, many such programs would appear to be closer to the State Department than the Sanitation Department because the resolution of many enforcement issues inevitably involves a discretionary judgment, the parameters of which are difficult to specify in advance.\textsuperscript{110}

3. Make-or-buy? The cost of adjustments (attributable to bounded rationality) and oversight (necessary because of potential opportunistic behavior) at some point makes reliance on private contractors for enforcement purposes more costly than using government for the same functions. This situation may arise more often than supporters of outsourcing believe, especially in situations where highly incomplete contracting is likely. While there is a cost to overseeing government employees, such employees have less incentive to act opportunistically and to exploit the agency's bounded rationality than do private, profit-seeking actors. Furthermore, the comparative cost of internal production may not be significantly more expensive once the government takes into account that outsourcing still requires an agency to have sufficient expertise to oversee the private contractor. Consider, for example, the FAA's apparent failure to monitor adequately private aircraft inspectors.\textsuperscript{111} If, as the GAO suggests,\textsuperscript{112} the FAA must spend more money on its oversight,

\begin{footnotes}
\item[108] Wilson, supra note 31, at 358.
\item[109] Williamson, supra note 8, at 331.
\item[110] See, e.g., Heckler v. Chaney, 470 U.S. 821, 831 (1985) (observing that prosecutorial decisions involve a "complicated balancing of a number of factors which are peculiarly within [the] expertise" of an agency).
\item[111] See supra notes 99–100 and accompanying text.
\item[112] See supra note 100 and accompanying text.
\end{footnotes}
including hiring more experts, it may be more cost-effective to hire government employees to perform the same services because they would not have the same incentive to cut corners as profit-seeking actors.

Because of the high cost of government enforcement, which requires adjudication and judicial review, it may still be less expensive to employ private actors, even taking into account the cost of effective oversight and monitoring. Employing private actors becomes more cost-effective if agencies can find ways to improve government oversight—i.e., to reduce measurement and governance costs. The literature contains a number of such recommendations, such as requiring government contractors to issue detailed reports about their activities. These are good ideas, but it is not clear how effective they are or whether they make outsourcing less expensive. If the government requires reporting, for example, it will raise the cost of hiring private actors to engage in enforcement activities. Moreover, even if private actors are required to make reports, an agency must still determine whether the information being reported is accurate.

4. Public Norms-Private Execution. There is a final factor that will affect whether hiring private enforcers reduces the government’s transaction costs. One of the criticisms of outsourcing government services is that private actors are not constrained in the same manner as government actors to obey such important norms as fairness, nonarbitrariness, and nondiscrimination. Indeed, private actors may be more efficient than the government actors to some extent precisely because they do not share these obligations. As Professor Freeman notes, the government can require private actors to meet these social goals, but doing so raises the transaction costs of both the private actor and the government. Private actors will have higher costs because they will have to obey the same public norms as public actors. The government will have higher transaction costs because it will need to monitor compliance with these norms in addition to monitoring compliance with the other contract terms. Earlier, it was

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113. See Schwaecr, supra note 80, at 337–38.
115. See Freeman, supra note 67, at 1285 (“Surely the state can exact concessions—in the form of adherence to public norms—in exchange for contracting out its work.”).
noted that hiring private enforcers may not reduce the government’s transaction costs in many instances.\textsuperscript{116} If private enforcers are required to comply with public norms, this would appear to be even more true.

\section*{B. Enforcement Settlements}

Agencies can hire private actors to perform enforcement services for them. The other type of enforcement contracting involves negotiations between an agency and regulated entities concerning the scope of enforcement. The settlement of enforcement cases is standard practice at all agencies. An agency, however, can act as an enforcement entrepreneur. This occurs when an agency negotiates an enforcement agreement that results in an outcome different than one that could be achieved through adjudication of the citation. OSHA will reduce a company’s fines, for example, in return for which the corporation agrees to implement a safety plan at all of its plants and not just the one that was found by the agency not to be in compliance.\textsuperscript{117} Similarly, the EPA will agree to reduce environmental fines in return for which a corporation adopts new, preventative efforts not required by law.\textsuperscript{118}

In both routine and entrepreneurial negotiations, the outcome is based on a contract between the agency and the regulated entity, rather than a legal order. From a transaction cost perspective, both of these approaches can reduce the cost to the government of obtaining regulatory compliance, and entrepreneurial agreements may make it possible for the government to obtain a better outcome at a lower cost than alternative ways of obtaining the same objective. Nevertheless, transaction cost analysis explains why traditional enforcement may be preferable to both approaches to enforcement.

1. \textit{Routine Agreements}. In routine enforcement agreements, the agency agrees to reduce the amount of the fine imposed and the regulated entity agrees to comply with the regulation or regulations the agency is seeking to enforce. The agency therefore avoids the costs of litigating the issue of compliance and defending any subsequent lawsuit challenging the outcome that a regulated entity might file. Thus, such routine agreements have the potential to reduce significantly the agency’s transaction costs.

\textsuperscript{116} See supra Parts IV.A.1–2.
\textsuperscript{117} See supra note 62 and accompanying text.
\textsuperscript{118} See supra note 63 and accompanying text.
This type of negotiated settlement is therefore generally preferable to traditional enforcement, but this conclusion assumes that the agency has acted in good faith in negotiating the enforcement settlement and that the agency ensures that the regulated entity actually complies with it. Experience indicates that agencies cannot always be trusted to act in this manner. Settlements can be used to water down regulatory protections and provide opportunities for de facto deregulation, and agencies can fail to ensure that companies live up to their negotiated settlements.

This type of bureaucratic drift presents a considerable agency problem for regulated beneficiaries and political institutions responsible for ensuring that agencies effectively enforce their regulations. Even if regulators act in good faith, however, the use of negotiated settlements in routine cases may not always be preferable to traditional enforcement.

a. Opportunistic Behavior. Although negotiated settlements generally reduce an agency's transaction costs, a strategy of reducing penalties to settle disputes and avoid litigation may be more costly in the long run if it leads to less regulatory compliance. When a firm determines whether to comply with a regulation, it considers the probability that a violation will be detected and the size of the penalty that will be enforced. Thus, the optimal strategy for a regulated entity may be to risk detection when an agency routinely settles enforcement cases for small fines. If a substantial number of firms behave in this manner, the settlement of regulatory violations for reduced fines can increase an agency's enforcement costs.

The enforcement literature suggests that agencies should adopt an enforcement strategy that distinguishes between regulated entities that are habitual offenders and entities that are likely to obey agency regulations, even if the second group has committed relatively minor


120. See, e.g., David Barstow & Lowell Bergman, Deaths on the Job, Slaps on the Wrist, N.Y. TIMES, January 10, 2003, at A1 (explaining the failure of the EPA and OSHA to stop hundreds of violations at plants run by McWane, Inc. after prior negotiated settlements).

121. Shapiro & Rabinowitz, supra note 74, at 106.
or technical violations. Reformers recommend that agencies impose token fines or provide training and information about compliance in return for an agreement by regulated entities that fall into the second group to come into compliance. The literature argues that many companies will comply with what they perceive to be reasonable government regulation and that a punitive approach is unnecessary and even counterproductive to gaining compliance. By comparison, the literature recommends escalating penalties for habitual offenders who are likely to take advantage of a cooperative enforcement policy in which agencies are continuously willing to settle cases for the payment of reduced fines.

122. See, e.g., IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 24 (1992) (asserting that an enforcement strategy “based mostly on punishment will undermine the good will of actors when they are motivated by a sense of responsibility”); EUGENE BARDACH & ROBERT A. KAGAN, GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS 105-06 (1982) (noting that when firms with good compliance records inadvertently violate regulations because rules are complex or ambiguous, managers are likely to regard punishment as unwarranted and unfair); John T. Scholz, Voluntary Compliance and Regulatory Enforcement, 6 L. & POL. 385, 385 (1984) (noting a cooperative policy requires “agencies to be reasonable toward cooperative firms, vengeful toward cheaters, unrelenting in pursuit of chronic evaders, but conciliatory toward repentant firms”).

123. See, e.g., AYRES & BRAITHWAITE, supra note 122, at 35 (recommending a pyramid strategy of enforcement with persuasion as the first option and small penalties as the second option).

124. Punitive approaches are supposed to reduce compliance for the following reasons. When a firm finds it difficult or inappropriate to apply general regulations to its specific circumstances, managers are likely to regard punishment as unreasonable because regulators fail to acknowledge that an exception from technical compliance is warranted. Further, if a firm inadvertently violates regulations because the rules are complex or ambiguous, managers are likely to regard punishment by the government as unwarranted and unfair, particularly if the violation is minor. A punitive approach by the government in these circumstances may encourage managers to actively resist enforcement efforts by contesting whether a violation occurred, even if the firm's legal costs will exceed the size of the fine, or forgoing future cooperation with the agency, such as refusing to cooperate with regulators in identifying and solving new problems. See Rechtschaffen, supra note 119, at 1203-05 (summarizing the arguments of proponents of regulatory cooperation); Sidney A. Shapiro & Randy S. Rabinowitz, Punishment Versus Cooperation in Regulatory Enforcement: A Case Study of OSHA, 49 ADMIN. L. REV. 713, 718-20 (1997) (same).

125. See, e.g., AYRES & BRAITHWAITE, supra note 122, at 35 (recommending a pyramid strategy of enforcement with significant fines and criminal penalties for chronic noncompliance).
b. Incomplete contracts. If it is assumed that a mixture of punishment and cooperation is the optimal enforcement strategy,\textsuperscript{126} what is the optimal mix of cooperation and punishment?\textsuperscript{127} Transaction cost analysis suggests a framework for addressing this make-or-buy issue. If an agency is dealing with an opportunistic firm, a punitive enforcement strategy will most effectively lower measurement costs, because opportunistic firms are more likely to exploit a cooperative approach, thereby increasing measurement costs for the agency. If the agency is dealing with a reliable firm, the agency can reduce its transaction costs by adopting a cooperative enforcement approach. Thus, the choice of the lowest cost approach depends on the agency's capacity to detect the reliability of the firm with which it is negotiating.

It is unclear, however, how readily an agency can detect whether it is dealing with an opportunistic or reliable firm because of its bounded rationality, but the agency can employ some heuristics as a guide. Studies of regulatory compliance suggest that certain factors make it more likely that a firm will voluntarily comply with agency regulations without the spur of administrative penalties.\textsuperscript{128} These factors address the extent to which a regulated entity is subject to marketplace or tort incentives to comply with agency regulations. In short, cooperative approaches appear to work best when the incentives for compliance of a regulated entity are aligned with the agency's enforcement goals.

2. Entrepreneurial Agreements. In a routine settlement, an agency seeks an agreement with a regulated entity that it will come into compliance with the regulations that it is charged with violating. In an entrepreneurial settlement, the agency and the regulated entity agree to a settlement that involves additional or different compliance.

\textsuperscript{126} See Rees, supra note 60, at 176 (comparing the pros and cons of cooperation and punishment, and concluding that neither "approach can be easily dismissed because each has much to recommend it").

\textsuperscript{127} Despite the enthusiasm for cooperative enforcement methods among some commentators, there is little empirical evidence concerning the effectiveness of this approach. See Shapiro & Rabinowitz, supra note 124, at 720 ("There is little empirical evidence on the relative effectiveness of cooperative and legalistic enforcement policies."); see also Rechtschaffen, supra note 119, at 1208 ("The limited empirical data actually comparing deterrence and cooperative-oriented strategies is mixed.").

\textsuperscript{128} See Shapiro & Rabinowitz, supra note 74, at 129–33 (suggesting several factors, such as the size of the business and the extent to which there are widespread social norms that compel compliance, that predict when a firm is likely to comply voluntarily with agency regulations).
Earlier, it was noted that both the EPA and OSHA have adopted this strategy.\textsuperscript{129} The EPA’s Project XL is the most celebrated example of this approach in the literature. Project XL invites firms to seek the EPA’s agreement to ignore certain regulatory violations in return for superior environmental performance in other areas.\textsuperscript{130} The goal for the regulated entity is to reduce its overall compliance costs by reducing some emissions more than the EPA’s regulations require while reducing other emissions by less than the EPA’s regulations require. For its part, the EPA agrees not to prosecute the firm for its underperformance.\textsuperscript{131} For this concession, the EPA gains a net environmental impact over what unadjusted application of regulatory standards would have been capable of achieving.

Project XL is similar to contractual standard setting because an applicant in effect proposes to the EPA that it agree to a different set of regulatory standards than the ones adopted after notice and comment rulemaking. The EPA’s use of the enforcement process instead of rulemaking reduces the cost of revising its regulatory standards as they apply to one regulated entity. As a variation of contractual standard setting, however, Project XL is subject to the same properties—opportunistic behavior and incomplete contracting—that increase the agency’s transaction costs.

\textit{a. Opportunistic Behavior.} When the EPA negotiates an entrepreneurial agreement, such as Project XL, it is negotiating with profit-seeking entities that opportunistically may seek to take advantage of this situation. The EPA therefore cannot expect that a firm’s assertion of net superior environmental performance is necessarily accurate. Yet, Project XL is built on the premise that regulated entities are in a better position than the EPA to identify the best way to reduce pollution. As noted earlier, the existence of asymmetrical information invites opportunistic behavior by a regulated entity because it is in a position to exploit its superior access to information to serve its own interests.\textsuperscript{132} As a result, the EPA must pay for the costs of verifying that the agreement proposed by a

\textsuperscript{129} See supra notes 62–63 and accompanying text.
\textsuperscript{131} EPA’s authority to make this concession is uncertain. See Rena Steinzor, Regulatory Reinvention and Project XL: Does the Emperor Have Any Clothes?, 26 ENVTL. L. REP. 10,527, 10,527 (1996) (noting the observation of EPA staff members: “[i]f it isn’t illegal, it isn’t XL”).
\textsuperscript{132} See supra notes 69–74 and accompanying text.
regulated entity is consistent with its regulatory mandate and mission. This does not mean that Project XL initiatives are not a worthwhile investment by the agency in appropriate circumstances, but it does mean that there may be significant resource implications in committing to a large number of such projects, because resources spent on these efforts are not available for conventional enforcement.

b. Incomplete Contracts. Just as the possibility of opportunistic behavior increases an agency's transaction costs when the agency negotiates an entrepreneurial enforcement agreement, the potential for incomplete agreements also increases the agency's costs. As discussed earlier, it is less cost effective for an agency to use contractual standard setting when the agency cannot adequately specify in advance the goals or parameters of the regulatory standard it is seeking. The EPA is in this position in Project XL. To ensure a positive net environmental impact as a result of the agreement, the EPA must have a way to measure the degree of environmental improvement that occurs. This poses two difficulties. First, the agency and the regulated entity must agree to a baseline according to which the improvements can be measured, and, second, the agency and the regulated entity must agree to a methodology by which the agency can measure the difference between the baseline and a plant's current emissions. These functions are particularly complicated when a proposal involves the trading of emissions between environmental media, e.g., trading decreased water emissions for increased air pollution, because of the dearth of reliable science concerning the long-term implications of such exchanges. As Professor Rena Steinzor explains: "High transaction costs . . . are most often triggered by the complexity of proposals, especially those that introduce such variables as cross-media and cross-pollutant trading, coverage of unregulated pollutants, and the anticipation of future regulatory requirements." This complexity leaves "participants hard-pressed to agree on a baseline for determining performance, much less a project's superiority—or equivalence—in relationship to the status quo."

133. See supra notes 79–81 and accompanying text.
135. Id.
In standard setting, the agency has the advantage that a proposed standard is subject to public comment during the rulemaking process, which may help reduce the agency's bounded rationality. Because the EPA adopts Project XL standards in the context of enforcement, it is under no such obligation. The EPA, however, has voluntarily created a process for obtaining comments from interested stakeholders. Although this step is useful, it creates transaction costs that the EPA can avoid if it simply enforces its regulations as written.

To summarize, entrepreneurial agreements create the opportunity for an agency to make regulatory adjustments as part of the enforcement process. While this presents an opportunity for the agency to adopt a more optimal level of regulatory compliance, the agency's transaction costs might be greater than if the agency sought the same outcome using traditional means.

V. SELF-REGULATION

Self-regulation is the last alternative to the traditional model identified in the typology in Part II. In self-regulation, an agency contracts with the same private actor to write regulatory standards and to enforce them. Self-regulation presents the type of transaction problems that arise in contractual standard setting and in contractual enforcement, but it is more costly for the agency than engaging in either of these functions separately, because the agency has transaction costs arising from both functions. As was the case regarding contractual standard setting and enforcement, these costs are a function of opportunistic behavior, incomplete contracting, and hold-up problems. In most instances, the costs associated with these properties are likely to exceed any savings that an agency gains by employing self-regulation. Thus, self-regulation is more likely to reflect the political power of the self-regulated industry than the product of rational decisionmaking by an agency.

137. See supra notes 65-66 and accompanying text. Because this choice involves a make-or-buy decision, it is assumed that an agency is proceeding under a regulatory regime that gives it authority to undertake regulatory functions, and the issue is whether to rely on self-regulation instead of writing its own standards and then enforcing them. An agency can regulate an industry for some purposes and rely on self-regulation for other purposes. Moreover, the agency retains the authority to withdraw self-regulation, or some aspect of it, if it determines that internal production better effectuates its legislative mandate.
A. Opportunistic Behavior

The first difficulty is that a self-regulatory body will be influenced by its self-interest in writing regulatory standards and in enforcing them. The problem is more extensive in this context than in contractual standard setting or enforcement because the self-regulatory entity has the ability to act opportunistically in both standard setting and in enforcement. This potential increases an agency's transaction costs as compared to relying individually on contractual standard setting or contractual enforcement.

The agency's costs are a function of the extent to which the incentives of the participants in self-regulation are congruent with the agency's goals. Private actors normally have different goals than a regulatory agency, particularly when they are profit-maximizing entities or are influenced by such entities. Earlier, it was noted that private standard-setting organizations tend to be dominated by interested corporations, which results in lowest-common-denominator regulatory standards. Because self-regulation also involves private generated standards, the same problem exists. The regulatory standards produced by the self-regulatory body are likely to reflect the interests of the industry it is regulating. Unless these interests are congruent with the agency's regulatory goals, self-regulation will not produce regulatory standards consistent with the agency's legislative mandate. The possibility that the industry's incentives will be congruent with the agency's goals is discussed below.

A similar problem exists concerning enforcement in self-regulation. When an agency relies on self-regulation, it is in the same position as when it hires private actors to enforce its regulations. As discussed earlier, profit-seeking private actors may attempt to reduce the quality of their enforcement services to make more money. Because of this potential, an agency must carefully monitor the actions of the private actors, which may lead to higher transaction costs than if the agency had chosen internal production in the first place. A self-regulatory body that is nonprofit will not have this incentive, but its enforcement activities are likely to reflect the interests of the industry it is regulating. Unless these interests are congruent with the agency's regulatory goals, self-regulation will not

138. See supra Part III.A.1.
139. See supra Part IV.A.1.
produce the same level of enforcement as will relying on agency employees for this function.

To sum up, the self-regulatory entity has the opportunity to act in an opportunistic manner regarding both standard setting and enforcement. This potential opens the door for self-regulation to reflect the interests of the regulated industry rather than the goals of the regulatory agency. This makes self-regulation a dubious proposition unless the industry has strong incentives to act consistently with the agency's regulatory mandate. Put another way, are there competitive, legal, or political pressures that are likely to ensure that self-regulation will result in the level of regulatory protection that the agency is obligated to provide?

One such potential incentive is that self-regulation would reduce the potential legal liability of the firms in an industry, because, if the firms voluntarily comply with regulatory standards, they can reduce the compensation that they might otherwise have to pay when they are sued in tort or contract actions. As previously noted, however, this situation does not involve an unregulated market. The agency is proceeding under a regulatory regime that gives it authority to undertake regulatory functions, and the issue is whether to rely on self-regulation in lieu of using one of the other approaches. By subjecting the industry to regulation, Congress has determined the common law liability system has failed to generate a sufficient level of protection and that regulation is necessary. Thus, it is not clear why self-regulation, motivated by the potential of legal liability, will produce the levels of protection that Congress intended. Moreover, Congress' enactment of a regulatory system indicates its preference to avoid litigation and to engage in preventative regulatory activity.

Another potential incentive for self-regulation is to head off regulation by an agency that may be more costly than self-regulation. If this is the industry's motivation for self-regulation, however, it hardly justifies an agency in relying on self-regulation to meet its statutory mandate to protect the public. There appears to be no point in an industry adopting this strategy unless it results in lower compliance costs than the industry is seeking to head off.¹⁴¹

¹⁴⁰. See supra notes 64–66 and accompanying text.

¹⁴¹. An industry might claim that self-regulation will produce the same level of regulatory protection as an agency, but at a lower cost, because the self-regulatory body would be in a better position to identify less expensive regulatory alternatives. An agency operating in good faith, however, would adopt these alternatives if they were suggested by the industry and if they were likely to result in the same level of regulatory protection.
The lone potential incentive that has some credibility is an industry's interest in promoting consumer confidence in its products or services. An industry may seek to gain market benefits by engaging in effective regulatory compliance. Self-regulation by the stock markets illustrates this situation. Because consumer participation in stock markets is influenced by consumer confidence in the integrity of market operations, brokerage firms generally have an incentive to implement effective self-regulation because their profits are related to the number of consumers who participate in the markets. Thus, this incentive aligns the industry's profit seeking with the agency's goals.

Recent events suggest, however, that not even the incentive of promoting consumer confidence is sufficient to curb opportunistic behavior by the self-regulated firm. In October 2003, a SEC staff investigation found, according to a news report, that the American Stock Exchange "routinely overlook[ed] rule violations by Amex specialists," and after "[t]he exchange promised to improve its regulation," it "then tried to cover up its failure to do so." A reporter described Amex as "captive regulators who did little." Earlier this year, the SEC also intervened in an investigation by the New York Stock Exchange into violations of its trading rules by some of its members, apparently with the result that the Exchange will impose higher fines than it originally had planned. In September 2003, the Chairman of the New York Stock Exchange was forced to resign after public revelations concerning his multimillion dollar compensation package. The revelations raised concerns over both the size of the pay package and the fact that the Chairman had his pay set by the managers of the firms that he regulated.

142. See Shapiro & Rabinowitz, supra note 74, at 113–16 (observing that a firm's safety and health compliance may determine whether ordinary and industrial customers purchase its products).
143. See Adam C. Pritchard, Self-Regulation and Securities Markets, REGULATION, Spring 2003, at 32, 33–34 (arguing that because exchanges seek to increase their trading volume, they have an incentive to police activities, such as insider trading or securities fraud, that discourage investors from buying stock).
145. Id.
146. Landon Thomas, Jr., S.E.C. Steps In as Fines Are Planned on 5 Firms, N.Y. TIMES, Oct. 17, 2003, at Cl.
147. Kate Kelly et al., Closing Bell: Grasso Quits NYSE Amid Pay Furor, WALL ST. J., Sept. 18, 2003, at Al.
148. Id.
seen the extent to which these regulatory failures can be attributed to the SEC's reliance on self-regulation of the stock markets. Still, these events do suggest that self-regulation is not to be trusted, even in industries where public confidence is important to the sales of their products. There is even more reason to be dubious about self-regulation in the context of health, safety, and environmental regulation.\textsuperscript{149} In these contexts, there is a more tenuous link, if there is any link at all, between a firm's reputation for regulatory integrity and consumer purchase of its products.\textsuperscript{150}

\textbf{B. Incomplete Contracting}

In self-regulation, the chance for opportunistic behavior is greater than in other forms of outsourcing. Likewise, an agency is likely to have higher transaction costs associated with incomplete contracting in the self-regulatory context.

In contractual standard setting, an agency's transaction costs are related to its bounded rationality. The more difficult it is for an agency to specify in advance the type of regulatory standard that is acceptable, the more likely it is that the agency will be required to rewrite the standard written by a private actor.\textsuperscript{151} The same would be true in self-regulation. To the extent that the contract between the agency and the self-regulatory body is incomplete, there is a greater likelihood that the self-regulatory body would not resolve information defects and value conflicts in a manner that an agency would find acceptable.

In self-regulation, however, the agency is likely to have higher transaction costs than in contractual standard setting. In contractual standard setting, the agency uses rulemaking to adopt privately developed rules, but in self-regulation many standards go into effect without this step. Because there is no rulemaking, the agency must develop the information about the adequacy of the regulatory standards on its own, which raises its governance costs above those associated with contractual standard setting.

\textsuperscript{149} See Rechtschaffen, \textit{supra} note 119, at 1196 (finding that there are "significant limits to relying on the consumer product marketplace as a way to reward positive environmental performance").

\textsuperscript{150} See Shapiro & Rabinowitz, \textit{supra} note 74, at 114 (concluding that the "general significance of market forces in the areas of... environmental and social responsibility is unknown").

\textsuperscript{151} See \textit{supra} Part III.A.2.
The previous analysis assumes that the agency carefully reviews the regulatory standards that the self-regulatory body produces. If it does not do so, there is an agency problem, because administrators will have failed to verify that self-regulation is in fact consistent with the agency's mandate.

Thus, as in contractual standard setting, it may be less expensive for an agency to write its own regulatory standards than to depend on private actors in situations where the agency is hindered by bounded rationality in specifying the goals or parameters of the regulation that the agency is seeking. As self-regulation has higher transaction costs than contractual standard setting, it is even more likely that internal production will be less expensive than self-regulation.

C. Hold-Up Problems

An agency should be cautious about adopting self-regulation because this choice is likely to increase significantly its transaction costs as compared to traditional regulation. The use of internal production reduces the agency's costs produced by its bounded rationality and the potential for self-interested behavior. In addition to the problems with opportunistic behavior and incomplete information, the hold-up problems associated with a self-regulatory approach should give agencies pause before adopting such an approach. The hold-up problem in this setting is similar to the one identified earlier concerning contractual standard setting, although the problem will be magnified in this context.

As discussed earlier, it may be more difficult for an agency to modify or reject privately generated standards than to have relied on internal production of the standards in the first place. The more financially valuable it is for an agency to adopt standards written by private actors, the more money corporations will devote to political action to ensure that result. When an agency is likely to find itself in this situation, internal production of standards is advisable.

The same potential exists concerning the employment of private firms to engage in enforcement. As discussed earlier, there is evidence that some prominent programs relying on private actors for

152. See supra Part III.A.3.
153. Id.
enforcement functions may result from political influence rather than from transaction cost analysis.\textsuperscript{154}

The same hold-up problem exists concerning self-regulation, but the regulated industry has an even greater incentive to protect the regulatory results than in contractual standard setting or contractual enforcement. The industry has a greater interest because self-regulation gives an industry greater potential control over the regulation to which it will be subject. This analysis suggests, for example, that the SEC's longstanding reliance on self-regulation of the stock exchanges may reflect the political power of the industry, rather than the SEC's independent judgment that self-regulation is the better way to achieve its mandate.

CONCLUSION

An economic actor will sometimes rely on other firms to produce the goods and services that it needs, and it will sometimes produce those goods and services itself, depending on which set of arrangements produces the lowest transaction costs. Economists analyze this make-or-buy decision using transaction cost analysis. This Essay contends that regulatory agencies have a similar make-or-buy decision when they decide whether to outsource government regulation, and that transaction cost analysis offers a useful framework to analyze this decision. This approach leads to the following conclusions.

Proponents of outsourcing argue that private actors can produce the same quality of performance at a lower cost than can government employees. The relevant question from a transaction cost perspective, however, is whether the total cost of outsourcing government regulation will be less than relying on government employees to perform the same functions. When the government depends on private actors for regulatory functions, it has the cost of contracting with those actors and monitoring their performance. These costs can exceed any cost savings created by relying on private actors to perform regulatory functions.

It is true that using government employees to write and enforce regulations has high transaction costs, but internal production should not be condemned unless there is a superior alternative. Regulation generates high transaction costs because it involves the resolution of

\textsuperscript{154} See supra notes 102–04 and accompanying text.
difficult collective action problems. Private parties may not be any more efficient in resolving these political problems, even if they are highly efficient in their economic activities.

A review of the government's regulatory functions indicates that outsourcing government regulation will be less costly in some cases and more costly in others. Thus, there is no a priori reason to conclude that outsourcing regulatory functions will decrease the government's transaction costs as compared to internal production.

In contractual standard setting, the government relies on private actors to draft regulatory standards, which are adopted using rulemaking. The government's transaction costs are a function of the extent to which standard setting involves making decisions on the basis of incomplete information and reconciling difficult value conflicts, and the extent to which profit-maximizing private actors influence the standard-writing process. Because these conditions are relatively common, outsourcing the writing of regulatory standards may not reduce the government's transaction costs as compared to internal production of standards in many instances. Agencies, however, can reduce transaction costs related to the second problem by using regulatory negotiation.

In contractual enforcement, the government relies on private actors to enforce regulatory standards written by the agency. If the government hires private actors to engage in enforcement activities, its transaction costs are a function of the extent to which an agency can specify the type of performance it is seeking, and the extent to which private actors have an opportunity to reduce the quality of their performance in order to increase their profits. Again, because these conditions are relatively common in the enforcement of government regulations, outsourcing enforcement may not reduce the government's transaction costs as compared to internal enforcement in many instances.

The government can also involve private parties in enforcement decisions by negotiating with them concerning the scope of regulatory compliance. If the agency is able to obtain compliance with its regulations by reducing the amount of the fine it imposes, it will likely reduce its transaction costs, because it avoids the cost of adjudicating such violations. An agency may not reduce its costs, however, when the negotiations involve entrepreneurial agreements that seek to modify the degree of compliance, such as Project XL. This type of negotiation in effect involves standard setting because it alters the degree of regulatory compliance. As such, it imposes the same
transaction costs that an agency confronts in relying on private actors to write regulatory standards. Because these costs are likely to be greater than adjudicating routine violations, this form of outsourcing government regulation may not reduce the government's transaction costs.

Finally, an agency can permit an industry to engage in self-regulation, which involves private actors in writing and enforcing regulatory standards. Self-regulation presents the same type of transaction costs that arise in contractual standard setting and contractual enforcement, but it is more costly for the agency than engaging in either of these functions separately. For this reason, this form of outsourcing government regulation may not reduce the government's transaction costs as compared to internal production of standards and enforcement.