

Capital Markets: The Rule of Law and Regulatory Reform

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Why drag the concept of the rule of law into a discussion of how to wring more nifty concepts out of the minds of scientists and entrepreneurs? Every time the regulatory rug is pulled out from under the feet of a long-term investor, it dampens his enthusiasm for investment. The results are short-term regulatory arbitrage and slower growth. This paper outlines some regulatory reforms to provide certainty and fairness to long-range investors and business planners.

Defining the Rule of Law

Dusting off the concept of the rule of law, we find it includes the essential elements of certainty and knowability, as well as the separation of powers, so that the ruler is not the judge in his own case. Why do we need for law to have such qualities? Because some dead jurists said so? Because it sounds nice, as an abstract philosophical matter?

No. It is because law in our society serves an essential *practical* function--that is, to supply the ground rules so that businesses, investors, and individuals can plan their actions to avoid disputes with one another. Disputes and the risk of disputes vastly raise the risk and cost of new ventures. That is, the most important function of the law is to *lower the risks of uncertainty in making long term plans*.

To judge whether investors currently enjoy the protections of the rule of law, therefore, we must assess the impact of the current regulatory systems on investors and inventors' ability to reduce their risk by providing a stable framework for making long-term plans. It is not enough, then, to provide knowability and certainty, to say that the law is written down somewhere in a law library. It is not enough to say we have a federal judicial system insulated to some extent from the political process, to provide for the separation of powers. These are formalities--just the beginning.

The Rule of Regulation

What is the state of the rule of law under our current regulatory system? In truth, the law is no longer a stable framework for investment--in innovation or anything else.

- Regulatory agencies enjoy broad discretion to describe policy under vague enabling laws passed by Congress, adding to uncertainty.
- Regulatory agencies often choose to enforce relatively vague rules on a "case by case" basis, adding to uncertainty.
- Congress and regulators take a short-run view of policy, passing industry-specific laws that then must be reformed in a few years, adding to uncertainty.

A prime example is the cable television industry. Cable prices were originally regulated at the local level, then deregulated by Congress in 1984. Cable rates were then reregulated in 1992 (followed by endless rulemakings at the FCC), rederegulated in 1996, narrowly escaping reregulation again since then.

What is an investor to make of all this? He has little choice to focus on the short run in any investment choices that he makes about cable--or put his money somewhere outside the heavily regulated telecom sector. And this in the long run meant that cable had less capital at the time of deregulation--capital they could have used to forge ahead with broadband networks.

Flexibility vs. Certainty

A great deal has been said about the importance of "flexible" rules to govern the fast-changing technologies--the need for panels of experts to tailor regulations to new technologies. Perhaps we must give up on certainty as a goal of high-tech law.

This would be a grave mistake. First, flexible rules established by panels of experts are probably better than rigid rules established by panels of idiots. But they are not better than markets. No matter how much expertise in economics and technology a federal panel of experts might possess, they still cannot even begin to plan an innovative economy. Entrepreneurs must bear risks and experiments in a process of discovering what consumers want, what they are willing to pay for it, and in assessing the opportunity costs of one investment as compared to another.

In a free market, a few general, certain rules give entrepreneurs flexibility--better known as *freedom*--to use their own expertise to adapt to changing circumstances. The laws bind all companies equally, establishing property rights and freedom of contract. This foundational law allows a lot of flexibility, because it is not very restrictive, and there are not so darned many pages of them. But such law also provides the benefits of certainty. Unlike broad, discretionary regimes of decrees promulgated by experts, laws in a free market reduce uncertainty and risk.

Proposals for Reform

This is not an easy problem to address. The uncertainty of law today stems from many factors--beginning with the broad discretion of administrative agencies, the short-run view of elected officials because of election cycles. Broad regulatory reforms are important to a return to the rule of law across the U.S. The following options should be investigated:

- *Eliminating unnecessary laws* decreases the scope of the uncertainty problem. Take a fresh look at radical deregulation of high-tech sectors like communications, such as (for example)
 - Reform of the process by which the electromagnetic spectrum is assigned and allocated, to support the creation of property rights and markets in spectrum.
 - Phasing out broad, meaningless standards such as the "public interest."
- *Abandon the principle that that which is not expressly permitted is forbidden*-- currently the rule for communications mergers and wireless licensing.
 - For example, the FCC's case by case review of mergers should be abolished, leaving the DOJ to consider such issues.
- *Congress should vote up or down on rules proposed by an agency before those rules became law.* This would help end the day of passing the buck to regulatory agencies by enacting vague laws.
- *Try to avoid industry-specific laws* that must be changed every few years in favor of general, lasting principles. For example:
 - Questions about whether broadband cable networks should provide access to competing ISP's should be resolved under general antitrust law.