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THE POLITICAL ECONOMY OF REGULATION

BY P. M. BOOTH, B.A., F.I.A., F.S.S.

ABSTRACT

This paper examines the political economy of regulation, reviewing market socialist, neo-classical and public interest approaches to regulation and analysing the development of financial services and insurance regulation in these frameworks. However, the paper suggests that these approaches do not capture properly many of the features of a market and the behaviour of regulators. Public choice theory is discussed, and it is concluded that there has not been significant capture of the regulatory process by interest groups. Austrian economics is proposed as a possible framework within which to analyse markets and regulators. It is concluded that there is prima facie evidence to suggest that the Austrian view of the market is realistic and that regulation in insurance markets can have unforeseen and undesirable effects. The author also concludes that, until 1970, insurance regulation did not deviate from principles which are appropriate if either a public choice or Austrian view is taken. However, the Financial Services Act 1988 and the Pensions Act 1995 do deviate from those principles.

KEYWORDS

Regulation; Financial Services; Public Choice Economics; Austrian Economics

1. INTRODUCTION

1.1 One of the most important influences on the development of an insurance market and on the development of professions is the nature of regulation. This paper looks at different approaches to regulation, and illustrates how those approaches are influenced by different schools of economic theory. It, therefore, develops the ideas on the economics of regulation in Adams & Tower (1994) and in Adams (1994). The paper also draws on actuarial work on the role of insurance supervision and of the profession, such as that in Daykin (1992) and Johnston (1988). In going beyond Adams & Tower (1994), the paper additionally considers the market socialist view of economic theory and that of the Austrian school, and applies their philosophies to regulation. An insight into the market socialist school has been obtained from the author's involvement with the development of the actuarial profession in Poland, which tried to develop a market socialist system in the early communist period. The development of regulation and insurance in that country is described further in Booth & Stroinski (1994, 1996). The Austrian school is distinct from traditional liberal neo-classical economics, and is known for its tendency to rejoin the different philosophical disciplines which have become distinct in recent centuries. The Austrian school,

therefore, has an important contribution to make to the understanding of the economics of law and the extent to which the legal framework should impinge on markets such as the insurance market. It is argued, in the paper, that Austrian economics also provides a deeper understanding of the advanced structures of the market than the neo-classical approach does. The role of the actuarial profession in the development of the insurance market is analysed in the Austrian framework. It is concluded that the profession could be regarded as one of those advanced structures. The Austrian framework for regulation is distinct from the public choice school, discussed in Adams & Tower (1994) and in Buchannan (1978). However, many of the conclusions which are reached from the two approaches are similar. The public interest view of regulation is rejected, from both the Austrian and public choice standpoints, as unrealistic and incomplete, as it does not analyse fully the behaviour of regulators as utility maximising agents who have imperfect knowledge; characteristics that they share with transactors in the market.

1.2 The structure of the paper is as follows. In Section 2 the author considers the market socialist view. In Section 3 the neo-classical view of economics is discussed, and the 'freedom with publicity' approach to regulation, which was underlying United Kingdom regulation between 1850 and 1981, is considered as a mechanism to correct the possible failure of the market to provide sufficient information. In Section 4 other possible failures of a free market are discussed, together with the methods by which regulators can overcome these failures. In 'public interest' theory, regulators can be said to work in the public interest to regulate markets to overcome the failures of markets. In Section 5 the author discusses public choice theory and the economic approach to regulation. The acceptance of these ideas weakens the public interest approach and leads one to question whether, in fact, market failures can be corrected through the actions of regulators. In Section 6 the philosophy of the Austrian school is discussed and applied to insurance regulation. It is found that the advanced structures found in the U.K. insurance markets give prima facie evidence for the Austrian position. Existing regulation is analysed in an Austrian framework. It is found that legislation passed since 1982 does not fit in with the Austrian philosophical approach to law, although earlier regulation did. As such, there is a danger that existing regulation may undermine the structures in the market which have evolved to protect the consumer. In Section 7 conclusions are drawn, and the principles on which future regulation should be based are discussed.

2. Market Socialism and the Control of Insurance

2.1 The term market socialism does not have an unambiguous definition. The concept was recently re-developed by Le Grand & Estrin (1989) and analysed by De Jasay (1990). One of the criticisms of De Jasay is that the concept of market socialism was not defined by Le Grand & Estrin in a way which made it subject

to straightforward analysis and criticism. However, one interpretation of the term, which is distinct from the other approaches to economic organisation described here, would be to define market socialism as the situation where productive resources are owned by the state, but where the state sets prices in accordance with marginal cost. In addition, people have freedom as to the occupations that they follow and have freedom in consumption. In terms of the productive process, this would effectively amount to a command economy, in the sense that the allocation of capital between competing uses would be determined by government.

2.2 The justification, put forward by socialist economists such as Lange, for a command economy, was essentially economic rather than political. Lange, for example in Lange & Taylor (1938), maintained that socialism allowed freedom of choice in consumption and occupation, with production being determined by demand prices and marginal cost. It was believed that complete regulation and state ownership of the insurance industry was desirable, because the central planning board would have a much wider knowledge of conditions, consumer preferences and costs in the economic system as a whole than any private entrepreneur would have under capitalism. This particular argument, therefore, recognised the market for its information processing role and maintained that the central planning board could perform that role more efficiently. In the market socialist system, the government's role in insurance is not just as a regulator, but in controlling every aspect of the market. It is worth noting that, because of the requirement in market socialism for prices to reflect marginal cost, there was a role in countries such as Poland, which began to develop a market socialist system, for actuarial expertise. The pursuit of market socialism, under the influence of the Polish economist Lange, was one of the reasons, identified in Booth & Stroinski (1994), for the survival of a limited actuarial profession and body of expertise in that country. Actuarial expertise was generally weaker in other communist countries.

2.3 The author rejects the validity of the market socialist argument for regulation, for reasons discussed in Sections 3 and 6. Also, in this paper, which is explaining the political economy context of U.K. regulation, it should be mentioned that market socialism has not been a point of view which has influenced the development of regulation.

3. Correcting Possible Failures in the Market for Information

3.1 In most economies the principle of private ownership is accepted as providing both the most rapid dissemination of information and the appropriate incentives to market participants to react to information signals. Relevant information would include costs of production of goods and services and preferences in consumption of economic agents. That the market processes and

reacts to information better than the government could would be accepted by both the neo-classical and the Austrian schools of economists.

3.2 In neo-classical economics consumers are seen to react to prices and to product quality, and to organise their consumption patterns in a way which is efficient, given their budget constraints and the prices they face. In the context of financial service provision, the security of an insurance company should be one of the features of a product that a consumer will consider when taking a decision to purchase an insurance product. Suppliers react to relative costs to find the most efficient way of producing a product. The process by which this maximises economic welfare, under certain conditions, is discussed in standard economic textbooks, such as that by Lipsey & Harbury (1988). Many of the justifications for regulatory intervention arise because the conditions under which competition is said to lead to the optimisation of economic welfare do not, necessarily, hold in practice.

3.3 An alternative justification for the free market is put forward by the Austrian school. Austrian economists see the market, primarily, as an institution for communicating and using information, that information being naturally dispersed (see, for example, Hayek, 1988; and Pirie, 1982). The free market is efficient because participants in the market only need to know information relating to prices and costs which is relevant for their own decisions. The information which is used by market participants is regarded as inherently dispersed, not only because it is necessary for market practitioners to know only the information which relates to their own situation, but also because information is subjective. It is not possible for the government to centralise the information regarding costs and benefits of a particular course of action, and use that information to direct productive resources and determine prices, because the costs and benefits of a particular action are known only to those who undertake that action. The further implications of the Austrian belief will be discussed in Section 6. However, it is worthwhile pointing out, at this stage, that, whilst the Austrian approach might suggest that detailed regulation and central planning could undermine the market, regulation which enforces the production of information may be compatible with the Austrian view.

3.4 Many economists will accept the principle of private ownership, but believe that government intervention can make the market work better. Given the way in which insurance regulation has evolved in the U.K., it is useful to divide those who take this view into two schools: those who believe in 'freedom with publicity'; and those who take what will be described as a 'public interest' view, which will be described in Section 4.

3.5 Those who believe in 'freedom with publicity' would justify the approach from a neo-classical economic viewpoint. Perfect information is one of the assumptions of perfect competition, made in neo-classical economics, which leads to the optimal allocation of resources (see Lipsey & Harbury, 1988). The argument, therefore, runs that, if the market is imperfect because of imperfect

information, the intervention of the government, to ensure that information is provided, can improve the workings of the market.

3.6 Adams & Tower (1994) discuss the role of regulation from this point of view. The rationale for the most basic regulation may arise from the possibility of inadequate incentives for market participants to provide information. This may be due to lack of competition or because of an unequal possession of information amongst market participants and the ability of the industry to suppress information. Consumers may not appreciate the value of information; thus market signals will not be transmitted to companies to provide it. Such a situation would provide a prima facie case for the 'freedom with publicity' type of regulation which used to exist in the U.K. A 'freedom with publicity' regulatory framework is quite distinct from market socialist or from corporatist approaches to regulation (see Section 4 for a discussion of a corporatist approach); the distinction is that the regulator acknowledges the sovereignty of consumers, and merely tries to ensure that they have sufficient information to take optimal decisions. In the presence of that information, the regulator does not try to direct the activity of either consumers or producers.

3.7 The first Insurance Companies Act 1870, described in Daykin (1992), followed the 'freedom with publicity' concept quite closely. Regular accounts had to be published, as did the results of actuarial investigations. The purpose of such disclosure is not to ensure that a member of the public could judge the soundness of an office directly, but so that an intermediary, an actuary or the Stock Market, can judge the soundness of an office. The information should then flow down to affect consumer preferences. The Appointed Actuary system became part of this framework. The system was proposed in the Insurance Companies (Amendment) Act 1973, and is described in detail in Johnston (1992). The Appointed Actuary system ensured that the information produced by the insurer in the 'freedom with publicity' framework could be traced to an identifiable professional. This was not a serious deviation from the 'freedom with publicity' concept, as the government did not seek to control the affairs of insurance companies, as long as relevant financial information was made clear. However, it was a limited deviation from the strict 'freedom with publicity' philosophy, as a partial management structure was imposed; an individual with a particular professional qualification had to be made responsible for providing particular information. However, that information, at the time that the Appointed Actuary system was developed, was still to be calculated on the basis of the actuary's own choosing.

3.8 Most later pieces of legislation were clear deviations from the 'freedom with publicity' concept, and will be discussed in Sections 4 and 5.

3.9 The concept of the Appointed Actuary was, in effect, enshrined in Friendly Societies 150 years before it was enshrined in life insurance companies. The Benefit Societies Act 1819, discussed in Nicoll (1898), required that two actuaries agreed the tables and rules of the society. At that time there was, in fact, no formal definition of an actuary nor an incorporated association of actuaries. In fact, this rule and the circumstances surrounding it are rather like those

surrounding the implementation of the Polish Insurance Law of 1989. The development of regulation in Eastern Europe, with particular reference to Poland, is discussed in Booth & Stroinski (1994, 1996). In Poland an actuary was required to certify the reserves of insurance companies, but no formal definition of an actuary was offered. At the time the law was passed no professional body existed, although one was set up in 1991. It is of interest to note that, in 1996, the Polish Government decided, not just to define the actuary in terms of membership of a particular professional body, but to set the examinations of the professional body itself. The way in which the development of statutory duties can lead to further government control than was the original intention of the legislation developing the statutory duties is discussed in Section 6.

3.10 The 'freedom with publicity' framework is not designed to minimise the probability of insolvency. Insolvency can occur, even in conditions of perfect competition, for a number of reasons. In the presence of perfect information, consumers may interpret information incorrectly, may not interpret it at all, or take risks which the consumer regards as too expensive to avoid (for example, a rational consumer may prefer an insurer to which a greater degree of risk is attached, but which has lower capital and lower product prices, than one which has lower risk, higher capital and higher product prices). The neo-classical framework, which can be used to justify the compulsory provision of information, suggests that consumers will analyse information to the extent to which it is efficient (such analysis may take place through the intermediary market), and that consumers may take risks, where those risks increase their welfare. An insurance failure should, therefore, never be regarded as providing a prima facie case for further regulation. In the neo-classical framework, that failure could have been optimal *ex ante*, in that given the information that consumers had available at the time and the costs of analysing that information, the probability of failure was such that consumers were satisfied with the risks they were taking. *Ex post*, people may re-assess their subjective probabilities of failure and, therefore, take more risk averse decisions or spend more resources on analysing information.

3.11 The 'freedom with publicity' type of framework can, therefore, be seen as a framework designed to improve the workings of the market, based on the assumptions implicit in neo-classical economics. It cannot be said to have significantly impeded the workings of the market, when applied to the regulation of insurance in the U.K., although it may lead to the production of a quantity of information which is beyond that which is optimal. The danger of the over-production of information is probably most clearly seen in the regulation of the marketing of financial services. MacGregor (1996) discusses regulation of the market for financial services. The information which insurance companies have to produce for customers has a significant cost, and it is not clear whether customers necessarily understand the information. Secondly, in order to ensure that the seller has sufficient knowledge about the customer and the customer has a sufficient understanding of his financial situation, 'fact-finding' forms have to be completed. There are three ways in which this situation could be sub-optimal in

the neo-classical framework, despite the fact that its development was based on the neo-classical premise that deficiencies in the market can be reduced through a 'freedom with publicity' approach: first, there could be an over-production of information, making products expensive for customers and leading the customer to expend excess resources on information analysis; secondly, because of the way in which the regulation has been implemented, the traditional principle of *caveat emptor* has broken down (this is because, even if he is given all the information which has to be provided, the customer can still take a decision which the regulator may regard as invalid); thirdly, it could be argued that the regulation has changed the structure of the intermediary market in a way which has made independent advice less accessible for some market participants. Such participants may find the accumulation and assimilation of information more difficult than before the regulation was developed. These points would suggest that, when regulation is developed with the 'freedom with publicity' concept in mind, the justification for the compulsory provision of information should follow directly from a clear manifestation in the market that some of the market conditions prevail which can lead to inadequate information provision. It is a simplistic interpretation of the conditions for perfect competition that the provision of more information must take the market closer to the welfare maximising position

4. THE PUBLIC INTEREST VIEW OF REGULATION

4.1 A public interest view of regulation could lead governments to take a more corporatist approach. The word corporatist does not have an unambiguous meaning. In this context it will be taken to mean a political environment whereby companies and property are privately owned, but are controlled by the government for certain reasons which the government believes to be in the general public interest. Justifications for such intervention may exist where assumptions which underlie perfect competition, other than those discussed in Section 3, appear not to hold. Also, other social objectives, such as price stability, investment policies which meet certain criteria, etc. may be pursued through the government taking a more corporatist approach. These wider issues, although of interest, are not central to the theme of the paper. Here the role of regulation will be discussed, where the purpose of regulation is to move the market closer to the situation which would exist under perfect competition, but where the market fails for reasons which are more fundamental than the existence of an information shortfall. The reasons why the government may intervene in this more fundamental way were discussed by Adams & Tower (1989) and Nicholl (1898).

4.2 Nicholl (1898) discusses the deliberations of the 1853 Select Committee of Parliament, which considered fully the role of the state in regulation, with particular reference to long-term insurance. The Select Committee suggested that, "even admitting the general wisdom of the principle of non-interference on the part of the Government in matters of trade, it has been contended that the

question of life insurance differs, in its general character, from ordinary trading transactions that it may fairly be considered as an exception to that rule." The reasons given as to why an exception should be made to the general rule of freedom to trade were as follows: life insurance relates to a very uncertain and remote period; it involves issues of an important and solemn character; and a contract cannot be abandoned easily once entered into, if the solvency of the office is in doubt. Familiar arguments were articulated against regulation, which will be discussed in Section 6.

4.3 Adams & Tower (1989) suggest other reasons why the government may develop regulation in the public interest. If an insurance company becomes insolvent there could be significant 'externalities'; that is costs imposed on individuals who were not party to any decision which led to the company facing insolvency or who had not contracted freely with the company. The argument for regulation here is very similar to the argument for regulation of pollution, on the grounds that pollution is a detriment to people who were not party to the decision to create the pollution. The externality argument can justify regulation of both entry into an industry and ongoing regulation of solvency.

4.4 A further reason for regulating insurers, discussed in Adams & Tower (1989), relates to the possibility that the market cannot overcome what is known as the 'agency problem'. Here it is suggested that the divorce between ownership and control within a business organisation leads to managers' objectives, rather than owners' objectives, being pursued. The case of mutual insurers, in which there is normally a further divorce between ownership and control (the control by the theoretical owners of capital is relatively weak in practice) is not mentioned, although this may provide further force to the argument. Adams & Tower report Boose (1988), who concludes that proprietary life companies, operating in the tightly regulated environment of New York, report lower expense ratios than other life offices in the country. The reason suggested is that regulator control substitutes for the more expensive ownership control. This theory would appear to take account of the diverse interests of managers and owners, but ignores the possible diverse interests of regulators and owners (see Section 5).

4.5 There is a sense in which there is no absolute distinction between the public interest view of regulation and the 'freedom with publicity' approach. The 'freedom with publicity' approach is a mechanism whereby the public interest can be achieved. Both approaches identify features of the market which, according to the neo-classical view of economics, would lead to a failure of the market to allocate resources optimally. Regulation is designed to correct that failure and may, therefore, increase welfare. However, common sense would suggest that there is a significant difference between the two approaches. In the case of regulation to correct the failure of the market to produce sufficient information, it is possible to develop abstract law which gives very little discretion to those framing or implementing the law. For example, the law may require the publication of accounts, certified as true and proper by auditors, containing figures compiled by an actuary. If it is believed that the market fails in other

respects, and that it is desirable to regulate the market to overcome these other defects, there is no general guiding principle by which regulators can operate. There is more incentive for the law to grow, finding more and more 'special cases', which require regulation to correct failures in the market. If the interests of regulators are different from those of consumers (see Section 5), it may be tempting for regulators to intervene to try to perfect what they regard as an imperfect market at every possible opportunity and perceived failure.

4.6 As we shall see later, it is possible to set up institutional frameworks, even in a system of regulation which is simply designed to encourage the production of information, which will lead to the development and expansion of regulation in a way which was not intended by its original framers. Nevertheless, the history of regulation does suggest that regulation is less likely to grow if it is based on a general principle (such as the need to provide more information than the market provides) than if it is based on a system whereby regulators have discretion to intervene whenever they perceive it to be 'in the public interest'. Indeed, a relatively stable situation existed between the 1870 Insurance Act and the Insurance Companies Act 1982, with regulation being based on the principle of 'freedom with publicity'.

4.7 There are two weaknesses in the public interest theory of regulation. The first weakness is that it concentrates on failure only in one part of the system; failure of the market to replicate the conditions of the simplified model of perfect competition. There is insufficient analysis of the possible failure of government and of the tendency for regulators to have interests different from those of market participants. There is also an implicit assumption that rectifying some aspect of an imperfect market will take the market closer to perfect competition and improve economic welfare. These weaknesses are addressed to some extent if the public interest theory of regulation is qualified by an analysis which considers 'public choice' theories of economics. Furthermore, neo-classical economics, with its emphasis on equilibrium conditions, may provide an incomplete understanding of the market economy. A better understanding of the market economy and the effect of regulation can sometimes be found in an Austrian framework. The public choice qualification of neo-classical economics and the Austrian view of the economic environment will be discussed in Sections 5 and 6.

5. PUBLIC INTEREST OR PUBLIC CHOICE?

5.1 In the public interest justification for regulation, it is often assumed that there exist disinterested regulators, who are able to develop regulation which has a foreseeable effect of bringing the market closer to the position which would exist under perfect competition. Adams & Tower (1989) describe how regulators may fail, in practice, to promote the public interest when regulating. The observations of Posner (1974) and Meir (1991), that regulators may fail because of a lack of knowledge and skills, because of the complexity of the issues and

because of inertia, can be put into a neo-classical economic framework. Also, the optimal allocation of resources in the neo-classical framework takes place partly because self-interested individuals respond to information about prices and costs. Such incentives may not exist in the public sector. There may be no clear relationship between reward and success to a regulator. Politicians, to whom regulators are ultimately accountable, do not always have an incentive to act in the public interest. At the most basic level, politicians would regard the successful regulation of insurance as only a minor issue in the whole range of issues which voters would consider when deciding upon a politician's re-election. The signals to a politician and a regulator to behave in the public interest are, therefore, both very diffuse and very indirect.

5.2 *Neo-classical theories of the market are, therefore, incomplete, because* they fail to explain the behaviour of regulators. In trying to expound a more complete theory of regulation, Adams & Tower (1989) discussed the ideas of capture theory and the economic theory of regulation. These theories should be considered alongside what is known as public choice economics. Public choice economics tries to explain the behaviour of those in government by placing their actions in an economic framework. In this section we will first explain the theories described by Adams & Tower (1989), and then put those theories into the more general public choice framework.

5.3 Capture theory predicts that the political process is dominated by interest groups, and that regulation can confer benefits on the groups that 'capture' the regulatory process. One interesting implication of this theory is that it would predict that regulation may be developed for the benefit of producers and not for the benefit of consumers. Producers, being a more concentrated group, with a common identity of interest and economically more powerful than consumers, are more likely to be successful at capturing a regulatory body and using it for their own interests than are consumer groups. Regulation may be justified by producer groups, when arguing in the political process, on the grounds that it is in the consumer interest, but, nevertheless, the motivation for the lobbying of producer groups may be that the regulation is in the producer interest. An example of the type of regulation which may arise by this process would be regulation regarding the capital requirements of new entrants. The justification may be consumer protection; however, the proposals may be developed to help existing companies prevent competition.

5.4 Regulation may also be influenced by groups within an industry. Historically, many of the professions were able to develop statutory monopolies over certain areas of work. Those monopolies were difficult to break down because of the interests of the professions by whom the regulatory process was captured. Some of the monopolies have been broken down (for example the opticians monopoly and the solicitors monopoly of conveyancing). As we shall see in Section 6, this type of capture does not appear to have taken place as far as the actuarial profession is concerned. However, the Appointed Actuary system, described in Johnston (1989), may be the beginning of a process of capture by

the actuarial profession. There are at least three indications that one could look for in trying to determine whether the Appointed Actuary system represents a process of capture. Firstly, the process of entry into the profession could be made harder (in order to keep the numbers who are able to perform the statutory functions relatively low); there is no evidence that this is happening. Secondly, the profession would seek to expand its statutory role; there may be pressure for this from some sources, although it was stated in 'The Future of the Profession' (1996) that, "Competition must be welcomed and met. It is the last resort of any profession to rely on statutory requirements to maintain its position. Such statutory work only follows from other capabilities" (page 378). Thirdly, actuaries would seek influence in the process which develops legislation and regulation. Capture theory would predict that the profession would use its influence, not to develop regulation in the public interest (to correct imperfections in the market), but would use its influence in the interest of the existing members of the profession.

5.5 One of the problems of determining which model of regulation gives results which are closest to those observed in the real world is that the predictions of different models may be the same in some circumstances. An additional difficulty is that a capturing group may well use public interest arguments (and certainly would not use self-interest arguments) when seeking further regulation. However, the author believes that it is difficult to argue that the Appointed Actuary system provides strong evidence of capture. The Appointed Actuary system probably does not, in fact, increase the market value of actuaries very much (because it relates only to a small part of the whole range of functions that actuaries perform).

5.6 The economic theory of regulation, proposed by Stigler (1971), suggests that regulation is an economic good, the costs and benefits of which can be analysed and the amount and nature of which is determined by the laws of supply and demand. However, regulation is not provided in the way that most goods are provided, through free, mutually beneficial exchange in a market. Politicians and regulators will provide regulation as long as there appears to be a demand from politically effective groups and as long as the opposition to regulation is not greater than the demand. The economic theory of regulation is, therefore, more complete than the public interest theory, because it analyses the forces which give rise to a demand for regulation and the costs and benefits of regulation. Capture theory and public choice theory predict that the costs can often outweigh the benefits. Regulation is not just provided by a benevolent far-sighted government whose main aim is to correct imperfections in the market, and which can see, with clarity, the exact consequences of its actions. Those in the regulatory process are, themselves, utility maximising agents.

5.7 The term economic theory of regulation is used because the framework uses ideas from economics (such as utility maximising agents and opportunity cost) to predict how regulators and politicians will use their power and to determine whether regulation is worthwhile. However, the author prefers to use

the term 'public choice' to describe the political economy framework in which regulation is determined, and will use 'cost benefit analysis' to describe the mechanism by which the overall benefits of regulation are determined. This is because the term 'economic' may imply that regulation is developed to confer an economic benefit on the users of the product of regulation, when, in fact, the economic benefit may accrue to a political interest group. Also, the terms 'supply' and 'demand', used in the economic framework to describe how the amount of regulation is determined, are, perhaps, misleading. In normal economic parlance these terms imply that an economic agent is taking a decision to supply or demand a product or service in order to maximise welfare, acting freely and faced with information about prices and costs and alternative courses of action. These conditions do not prevail in the political process, and the author does not wish to give the impression that regulation supplied to meet demand in the political process is necessarily economically beneficial; the whole point of the economic framework, underpinned by public choice economics and capture theory, is that it predicts that regulation is not necessarily beneficial.

5.8 It is worth referring to the original architects of public choice economics, as they provide interesting insights into the way in which economic agents may work in the political process. Niskanen (1973) describes the way in which public goods can be supplied by bureaus. (Bureaus could be loosely defined as agents of the state which provide a good or a service. For example, it could include the Government Actuary's Department providing the service of supervising insurance companies.) It is suggested that the primary function of bureaus is to supply goods that cannot be sufficiently well defined to be supplied by voluntary contract. This is compatible with the public interest view of regulation; regulation of solvency cannot easily be supplied by contract, and, therefore, the government can correct that failure of the market by supplying the regulation. Where an economic model of the political system adds to the insights of the public interest approach is that it looks at the motives of maximising individuals within the bureaus. This includes the role of collectives working through the political system to encourage the formation of bureaus. Just as one of the reasons for regulation in the public interest model was an asymmetry of information between the supplier of the product and the person buying the product, such an asymmetry also exists in the bureau between the sponsor (the taxpayer, the government or the consumer) and the bureau. The bureau is the monopoly supplier of regulation, so that the power of the bureau and its ability to maximise its own utility (perhaps by requiring over-regulation and providing it inefficiently) is considerable. The asymmetry of information makes it very difficult to reduce the power of the bureau, through the political process, because of the ability of those supplying the regulation to dominate the argument using their superior access to information.

5.9 Even if the aim of the bureaucrat is benevolent, and even if he has superior information compared with the sponsor on whose behalf he acts, he will not necessarily supply regulation in the optimal quantity. This is simply because

the bureaucrat cannot collect all the information necessary to understand the preferences of the individuals on whose behalf he regulates. Also, he cannot simultaneously satisfy all those preferences, particularly as they may often conflict; consumers will have different propensities to take risks and will be willing to pay different costs to reduce risks in financial services and in other fields which are regulated (such as public safety).

5.10 The other aspect which needs to be taken into account in the public choice framework is the behaviour of voters. Many theories have been put forward to explain the outcome of a democracy and its implications for the provision of government services. It is not necessarily possible to draw firm conclusions, although some possible outcomes may be described. (Fellows of the Institute and the Faculty of Actuaries may be interested to know that public choice economics, to some extent, owes its origin to the observations of academics working on university committees. Some of the conclusions about how voter preferences are reconciled may be familiar to actuaries who work on the committees of the Institute or the Faculty of Actuaries). It is likely that no group will be entirely satisfied with the package of public services which are received from the government (including regulatory services). It is also quite possible that there is not a majority behind the particular package of services which is provided. In a two-party system, it is possible that the preferences of the median voter will be satisfied in the political system (the conditions for this are discussed in Buchanan (1978) and the references contained therein). Another possible outcome can be seen if we consider the observations of Burton (1985), who described a problem similar to the prisoners' dilemma. The problem was given an intuitive reinforcement by Friedman & Friedman (1985). It is possible that the beneficial interest to those demanding the provision of a service by the government is concentrated within a small group (including the bureaucrats involved in the supply of the good), and the detriment to those who suffer may be dispersed across a large group. In the political process it may be possible for all to have their particular beneficial interest satisfied, because nobody is willing to fight strongly against it. All groups may be better off if none of these beneficial interests were met by the government, but, as in the prisoners' dilemma, the participants in the political process are never able to meet together and enforce an agreement that none of the particular beneficial interests will be met. These public choice models predict significant over provision of government-provided services, including regulation. Public choice economists look for rules which will reduce the provision to that closer to an optimal level; these rules may include written constitutions which limit the power of government or ways of structuring bureaus to ensure that the objectives of the bureaus are coincident with the interests of the public.

5.11 Thus, there are a number of strands of public choice economics which can be applied to the theory of regulation. The benevolent far-sighted regulator is replaced with a possibly self-interested regulator, who is not able, and is not necessarily willing, to act completely in the public interest. (Although the fact

that the bureaucrat is unable to act in the public interest, because he is unable to know and satisfy the preferences of all the public, does not mean that he is not dedicated to his area of expertise.) We have interest groups who try to capture the political process in order to seek benefit from regulation. We also have voter groups, all of which may prefer a situation with no public provision to the status quo, but which all prefer to have regulation or other service provision in a particular area of interest, given that other public goods will be provided to other interest groups. There is also an asymmetry of knowledge between the regulator and others involved in the political process. The main prediction of this model is over regulation (because of the nature of the political process) and inappropriate regulation (because it is not possible for those involved in the political process to know and satisfy the conflicting preferences of those who benefit from the production of regulation).

5.12 The public choice theories clearly add something to the neo-classical theories and public interest ideas. They recognise human nature and utility maximising operators in the political process. They also recognise that the government can provide services and allocate resources through a democratic process which is different from the market process in which resources are allocated by free exchange. To what extent has regulation in the U.K. been influenced by interest groups or been badly formulated by self-interested bureaucrats who cannot necessarily understand the preferences of those who operate in the market?

5.13 The Appointed Actuary system in life insurance has already been mentioned. It was concluded that it does not provide conclusive evidence of regulatory capture. A good indication of whether a system has been captured is the extent to which consumers, rather than producers, lobby for regulation. There is a debate within the actuarial profession about the need for an Appointed Actuary system in general insurance. If this were granted, as a result of pressure from the actuarial profession rather than as a result of pressure from other interest groups, it could provide a prima facie case for capture. It has already been mentioned that the regulatory system before 1980 could broadly be said to be a 'freedom with publicity' system within a public interest framework. Since 1980 there have been three major developments: the Insurance Companies Act 1982 (which consolidated the accounts and statements regulations of 1981); the Financial Services Act 1986; and the Pensions Act 1995. None of these developments could be modelled in the 'freedom with publicity' framework. In addition, there is anecdotal evidence that much of the professional guidance issued by the Institute and the Faculty arises as a result of pressure from regulators. If professional guidance arises from political pressure, it really forms part of a 'contracted out' regulatory system rather than being the guidance of the profession, which is a product of the spontaneous order of the market (see Section 6). If professional guidance does arise as a result of political pressure, it should really be analysed in the public choice framework in the same way as explicit regulation is analysed.

5.14 The Insurance Companies Act 1982 requires a great deal of standard information to be presented to the Department of Trade and Industry. See Abbott (1984). It also prescribes, in detail, the way in which a statutory valuation should be carried out. Thus insurance company regulation could be seen to have gone through three phases: prescription of information which should be made available to the public (at the level of detail at which it could be understood by financial professionals); prescription of a particular management structure and of a professional who should have responsibility for providing the information; and then prescription of the method and bases used to calculate the information. Has the system been captured, and, if so, by whom; or did the regulation arise through forces of demand operating through the democratic system?

5.15 The author cannot find any evidence for a public demand for further insurance regulation at the point at which it was strengthened. Daykin (1992) suggests that the more detailed requirements in the accounts and statement regulations where introduced after detailed discussions with the actuarial profession (although this does not mean that the profession supported their introduction). The valuation requirements were brought in as a result of the European Communities Life Establishment Directive of 1979. The author would argue that the philosophies which underlie European Union law do show evidence of bureaucratic capture.

5.16 The Financial Services Act 1986 does show evidence of a public choice framework operating and also of capture at many levels. Firstly, as has been pointed out by Veljanovski in Seldon *et al.* (1988), no cost benefit analysis was performed before the regulation was introduced. It is difficult to argue that public interest was the driving force behind the law when no appraisal of the costs was carried out. The various self-regulatory bodies and the Securities and Investment Board would appear to be in a position whereby they can develop arbitrary regulation which enforces what they believe to be best practice, without regard to the cost to the consumer. It could be argued that the lack of direct control of those bodies (either through the political system or through the market process) enables them to capture the system. The system has also possibly been captured by the providers of financial services (including intermediaries and insurers) who benefit from restricting competition. This is discussed both by Goodhart and by Kay in Seldon *et al.* (1988). The outlawing of certain practices under the Financial Services Act would appear to have restricted entry to the market. For example, the restriction on cold calling (Section 56 of the Financial Services Act 1986 specifies that contracts made as a result of cold calling are not enforceable unless regulations are made to specifically allow it) may restrict the entry of small brokers, due to the costs of other forms of selling. Polarisation has made it very difficult for smaller independent brokers to operate, because of the costs of surveying all products in the market. However, some brokers have combined resources by forming into networks to enable economies of scale in administration and research. The costs of compliance for small insurers and

Friendly Societies may exacerbate the trend towards concentration in the life insurance market and restrict entry.

5.17 Whilst there is the possibility of capture, it is also likely that many of the difficulties which have been pointed out in the Financial Services Act arise as a result of government failure in trying to correct market failure. This failure will have arisen due to the imperfect knowledge of bureaucrats and because of the pressure through the political system. Many of the rules issued by the regulators, under the terms of Financial Services Act, relate to disclosure (for example of commissions), and significant parts of the Act relate to best practice in selling, record keeping and to the polarisation of the intermediary market. In a sense, all these regulations can be justified from the point of view of trying to perfect an imperfect market. However, as has been pointed out, the costs of regulation, including the costs of information provision, were not considered by Professor Gower in his report which led to the Financial Services Act. Furthermore, perhaps there was insufficient recognition of the inability of governments to correct failures in markets. The costs of the Financial Services Act 1986 are discussed in Simpson (1996). Simpson reports the City Research Project, which estimates that direct administrative costs of regulation grew by 80% in real terms between 1987 (before the Financial Services Act came into force) and 1992. All the direct costs of regulation can be passed down to the insurers (and often from there to the consumer) through higher membership fees. Simpson further points out that many of the actions of the regulatory bodies have come too late to prevent the mis-selling problems that they were set up to deal with. Furthermore, because of the interests of those involved in the regulatory system, those measures which have been developed to promote competition (such as disclosure) have been significantly delayed. Thus, if Simpson is correct, the Financial Services Act 1986 exhibits many of the features predicted by the public choice framework. There would appear to be interest group capture; bureaucratic capture; regulation as a result of political pressure; government and regulator failure; and no attempt to assess the costs and benefits of regulation to the customer before proceeding with regulation.

5.18 The Pensions Act 1995 was a reaction to the Maxwell scandal and was drafted in response to the Goode Report. Professor Goode, like Professor Gower, was a lawyer, rather than an economist, and this may have been reflected in some of the recommendations of the report: Goode (1994). In particular, the minimum solvency standard that was proposed was a highly prescriptive regulation which attempted to provide a legalistic, scientific and objective method of determining a subjective quantity. As far as the actuarial profession is concerned, the major clauses of the Pensions Act are probably those relating to the Minimum Funding Requirement (the revised minimum solvency requirement). The effects of the Pensions Act on the funding levels and investment strategies of final salary pension schemes of the Pensions Act may be relatively limited, for reasons discussed in Booth & Matysiak (1996). There is not a clear indication of capture, either by the professions or by the industry, in the framing of the regulations.

However, there may be an indication of bureaucratic capture (the development of regulation to serve the ends of the regulators) and of government failure. It is probably reasonable to say that there was significant political pressure for further regulation of pension schemes in the wake of the Maxwell crisis, and thus the regulation could be seen as a policymaker's response within the public choice framework. The implementation of the Pensions Act gives significant discretion to the Secretary of State to develop regulation, and, indeed, the Institute and the Faculty of Actuaries' Guidance Note 27 had to be approved by the Secretary of State. This guidance should, therefore, be seen as part of the regulatory framework. It is possible that this move to bring the regulator and the profession closer could lead to a greater likelihood that the system will be captured. There are further aspects of this method by which the Pensions Act is being implemented, which will be discussed in the next section.

6. Regulation and Austrian Economics

6.1 Whilst it is theoretically possible to analyse the costs and benefits of regulation in a neo-classical and public choice framework, it will be argued, in this section, that such a framework can be inadequate, as it can emphasise the wrong issues. An Austrian framework would lead one to reject the public interest view of regulation as unattainable and the public choice view as incomplete. It would emphasise the imperfect and disequilibrium nature of markets and the role of the market in discovering information and in innovation. It would also look at the more detailed structures of the market at a more subtle level than the neo-classical framework would. If one looks at the market in an Austrian framework, it is less likely that it will be concluded that there are obvious deficiencies in the market which can be remedied through centralised regulation.

6.2 In this section the relevant precepts of Austrian economics are considered. We then ask whether the insurance market has the characteristics which are indicated by the Austrian view. The regulatory structure is then considered, with a view to determining whether insurance regulation has fitted a framework which can be derived from the principles of Austrian economics. In Section 7 we then consider how current regulation could be adapted to accord to Austrian principles. In the Austrian framework, as much emphasis is placed on the structures of regulation as on the details. In this sense, there is common ground between the Austrian school and the public choice school, because it is recognised that, if the wrong structures exist, the self interest of those regulating can overtake the public interest.

6.3 The body of Austrian economic theory is more difficult to summarise than neo-classical theory, as, rather like 18th century economics, the discipline is very much conjoined with other disciplines of philosophy. The main precepts of the school are discussed in Hayek (1960, 1982). A good summary of some of the ideas is discussed in Hayek (1983, 1988) and Pirie (1982). Huber (1996) has a good discussion of the role of certain Austrian principles in scientific analysis.

6.4 The market and competition are regarded as information gathering and assimilating structures and processes. Market exchange involves a constant process of trial and error, in which evolution through the market leads to the development and survival of better practices. This is not just a random or haphazard process. The incentives exist, in the market, for better practices to thrive and those practices which fail to die out. Companies will not make profits, for example, unless they produce good products. Also, the information about costs and preferences to market participants, of different products and methods of production, is more likely to be disseminated and acted upon in a market than in a centrally planned system. This is partly because the benefits and costs of particular actions are known only to those individuals who are undertaking those actions (they are subjective); by their nature that information is, therefore, decentralised and cannot be centralised. It is also because the detailed consequences of our economic actions can rarely be foreseen, but that, whilst this matters in a centrally directed or planned economy, it does not matter in a market economy, which can develop its own spontaneous order, with that order meeting the requirements of consumers more effectively than a centrally regulated order. (Academic rationalists often find difficulty with the idea of a beneficial order developing spontaneously without central direction. It has to be understood that such an order is not haphazard or random, although it is constantly changing and evolving. It is, nevertheless, stable and meets consumer needs better than a directed order could. The spontaneous order requires a market system operating in relative freedom, with abstract laws applying equally to all participants in the market. The market will then respond and evolve by a process of trial and error. Hayek (1988) compared the process with biological evolution. He noted that it was interesting that academic rationalists were often atheists who believed in biological evolution, but who also believed that economic actions had to be centrally directed, to achieve a stable order. It might also be of interest to note that Christians, on the other hand, often believed that biological processes were centrally directed, but that the market was best left to evolve! This latter observation is a paradox, although Hayek may be pointing out a contradiction. The latter one is only an *apparent* contradiction, because it is possible to believe that an all-knowing God directed biological processes and created a race of humans with capacity for error, but that, because the market is a human institution, it cannot be successfully directed by those imperfect humans.) People will make mistakes, but will have the incentive to learn from those mistakes. Good practices in a market will, therefore, survive, and those which do not satisfy customers will die out. This is effectively described in Hayek (1988), who develops a theory of the market order based on the evolution of beneficial practices in a community. Hayek suggests that "in the extended order most ends of action are not conscious or deliberate" (page 75). Furthermore, it is suggested that "the whole structure of activities tends to adapt through these partial and fragmentary (market) signals, to conditions foreseen by and known to no individual, even if that adaptation is never perfect" (page 76; the insert in

brackets is the author's). If the detailed ends of the actions of market participants were rarely known, it would be impossible to plan the means (which is essentially what regulation involves; achieving particular ends by particular means), at least to the exclusion of other means of achieving the unknown ends. The apparent inability of planners (including regulators) to centralise economic information casts doubt on their ability to regulate the market in the public interest; even when regulators are benevolent.

6.5 This framework would appear to suggest that detailed regulation will not normally be desirable. However, it will also be impossible to predict when it will be desirable, from a cost benefit analysis point of view. The market consists of millions of individuals, all of whom have different degrees of knowledge, different preferences (in insurance, different individuals will have different preferences for the products that they wish to buy and also different preferences for the security of the provider relative to the cost of provision). It would not be possible to determine, in advance, the extent to which regulation will satisfy more preferences than an unregulated environment. Austrian economics also predicts that the market is the most effective mechanism for disseminating information and satisfying preferences. Variety can exist in a market which can lead to the satisfaction of more preferences than in a regulated market. However, the market is also a process of discovery. It will anticipate consumer preferences and develop mechanisms to satisfy those preferences, because participants in the market can gain from this. The market will not always provide the best way of satisfying preferences, but there are greater incentives in a market, than in a political system, to ensure that good practice prevails and mechanisms develop to meet the concerns of consumers. Because costs and benefits are subjective, the market may develop institutions to satisfy consumer preferences which seem, in some sense, inefficient, *ex ante*, to those observing their development. It is, therefore, of interest, when looking at the Austrian perspective, to consider whether market structures have grown up which are of a form which may have been unpredictable, but which, *ex post*, seem to have served a useful purpose. These structures may include a whole range of professions, intermediaries, information providers, etc., which evolves to fulfil a role in an imperfect market, often developing to anticipate consumer need rather than in reaction to a demonstrated need. Regulators, on the other hand, may react to events more frequently than they anticipate them; the Financial Services Act 1986 and the Pensions Act 1995 being particularly good examples. Politicians are not in a position to centralise the information which exists in the market to develop structures which will anticipate the needs of consumers.

6.6 There is also an emphasis, in Austrian economics, on the inter-linking of law and economics and on the way in which legal structures can undermine or support free competition. Austrians would believe in a framework of general laws, the effect of which was predictable. Austrians, also, would not believe in giving a great deal of administrative discretion, either to politicians or to bureaucrats. Administrative discretion should be limited for a number of reasons.

Firstly, bureaucrats and politicians cannot have the information to improve on the outcome of the market by taking discretionary acts; secondly, it centralises power, and therefore undermines the ability of individuals to pursue their own preferences in the market; thirdly, it leads to uncertainty as to the rules by which participants in the market operate. The idea, proposed in the economic theory of regulation, that regulators could look at the costs and benefits of regulation and develop the economically optimal amount, would seem an impossible task (although this does not mean that some kind of cost benefit analysis should not continue to be undertaken when developing regulation). Austrians would certainly see some merit in the comments of the Bank of England (1996) that, "Heroic attempts have been made by various academics to measure the costs of regulation: quantifying the benefits is even harder. It may be more fruitful to focus on the issues which regulation is attempting to address and consider whether there are lower cost ways of addressing them"(page 468).

6.7 An explanation of the purpose of law is given in Hayek (1982). Taking a cost benefit approach to regulation could be said to be undermined by the observation that, "Nor can the choice of the appropriate set of rules be guided by balancing, for each of the alternative set of rules considered, the predictable favourable effects against the predictable unfavourable effects, and then selecting the set of rules for which the positive net result is greatest; for most effects on particular persons of adopting one set of rules rather than another are not predictable." (Volume **2**, page 3). In an explanation of the kinds of principles which should underpin law, it was suggested that, "The rules of conduct which prevail in a Great Society are thus not designed to produce particular foreseen benefits for particular people, but are multi-purpose instruments developed as adaptations to certain *kinds* of environment because they help to deal with certain *kinds* of situation." Anti-monopoly laws would certainly pass this test. Laws imposing a certain structure on the intermediary market (such as polarisation) would not.

6.8 In what could be seen as a serious criticism of the public interest approach to regulation, Hayek (1982) suggests that, "if the factual requirements for perfect competition are absent, it is not possible to make firms act as if it existed." (Volume **3**, page 70). In a sense, this is confirming an observation of the public choice school that regulators cannot perfect an imperfect market because they, themselves, will have their own preferences that they will wish to satisfy. However, it goes further than this, because it is also suggesting that a market, fundamentally, cannot be perfected by a regulator, because the whole purpose of a market is that decentralised information is used to allow the market to allocate resources efficiently. No regulator can know what the structure of an imperfect market would have been if it had been perfect, and even less what the outcome would be. Those structures and outcomes cannot, therefore, be simulated. Trying to create a perfect market out of an imperfect one is likely to have unforeseeable, undesirable effects.

6.9 Neo-classical economics often concentrates on modelling equilibrium

outcomes. Austrian economics recognises that markets are dynamic and will be constantly trying to adapt to new information and chasing new equilibrium positions. Disequilibrium analysis is often more interesting than equilibrium analysis. Markets may never be in equilibrium at any given time. Thus, the important question in determining whether and to what extent to regulate is not "does the market outcome appear imperfect?" but "are there deficiencies in the structure of the market which are hindering the market from reacting to new information and satisfying the needs of consumers?" There will be no time at which the market outcome appears perfect, but consumers may still learn more quickly, and the market react more appropriately, to mistakes which are made than a regulator could. The real test of whether a market has failed is not the occasional fraud or other undesirable outcome (such as the Maxwell affair), but evidence that the market does not seem to be learning from the event. One could then look to the structures of the market (for example the competitive structure) to see whether the structure of the market was hindering the learning process.

6.10 Regulation may also stifle innovation. By the nature of innovation, it will not be possible, once an activity is directed by regulation, to predict the innovations which are being stifled by regulation. Thus, even if a regulation appears desirable at a given time, it will be very difficult to determine when that regulation should be repealed or adapted. Hayek (1960) refers to building regulations, and comments that they can take the situation at a given time and place and make the standard method the only permitted method, thus becoming a serious impediment to desirable economic developments by preventing experimentation. This may explain why frameworks of abstract regulation, such as the Insurance Companies Act 1870, may appear out of date less quickly than detailed regulation, such as the regulation which arose from the bodies set up by the Financial Services Act 1986 or the regulations in the Insurance Companies (Amendment) Act 1973 (which were superceded after about 20 years).

6.11 The arguments put forward for greater regulation of life insurance by the 1853 Select Committee have already been referred to. The arguments put forward against regulation, by the Select Committee, would seem to fit in with the Austrian view of regulation. They suggest that the Acts which had previously been passed had been hurtful, rather than beneficial, in terms of their ability to achieve the objects that they had in view. It is suggested that regulation could stop the free development of the market and could prove prejudicial by lulling private prudence and vigilance (i.e. stop the market from performing its discovery and learning functions), and that this may outweigh any benefit of increased security.

6.12 Thus, how are we to determine whether the Austrian view of the market mechanism is a reasonable one and whether its conclusions regarding regulation are correct? It is impossible to come to a definitive conclusion about this matter; however, we can look at some evidence. For example, we can consider whether lightly regulated markets have generally evolved in a way that has satisfied consumer preferences better than highly regulated ones. We can consider whether

the market mechanism has been able to evolve the advanced structures which are necessary to ensure that consumers' sophisticated needs are met. We can also see whether highly regulated markets have not developed those structures. We can look at the effects of regulation, in particular whether there have often been unforeseen detrimental effects, which could be said to have arisen from trying to perfect an imperfect market. Finally, we can look at whether an overall order has developed, in an unregulated system, which does not appear to rely on regulation for its stability, but appears to be reasonably effective in fulfilling consumers' needs. We will only look at limited evidence in order to find if the Austrian paradigm has something to offer as an alternative approach to those discussed above.

6.13 It is important to appreciate that the structures that will develop in the market will not be predictable in advance. Their precise form in different environments will also be different. It is felt that the history of the development of the actuarial profession in the U.K. gives some credibility to the Austrian view. When the profession developed in the mid 19th century, the regulation which existed at the time was limited in scope and certainly would not be regarded as excessive by either the Austrian or the public choice schools. It is of interest to ask whether the Institute of Actuaries has developed as a sophisticated extension of the market order, in order to provide some of the functions which are also the objectives of regulation, but provide those functions in a way which does not undermine the structure and functions of the market. If this is the case, then it provides evidence that the market, itself, is capable of responding to the unique nature of life insurance, which was a concern of the 1853 Select Committee, discussed in ¶4.2.

6.14 The Institute of Actuaries would not have appeared to behave as an organisation which was interested in capturing the regulatory system or in creating professional monopolies. It also appears clear that the government of the day was happy to approve the formation of the Institute of Actuaries, but on condition that it did not indulge in restraining trade and did not receive favours from the government. It would appear to be a pure product of the market mechanism. Nicoll (1898) reports that "From what has preceded, it would seem as if there had not been much in the way of aid or protection accorded by the State to the actuarial profession in the performance of its duties. Our Free Trade Government has, however, been rightly — as it seems to us — very chary at all times of seeming to favour any particular society, or set of individuals, more especially if that favouring was at all likely to be at the expense of other members of the community." Perhaps, most importantly, "It is really very doubtful whether the policy of non-interference is not, in most circumstances, the best for a Government to pursue; and, as regards the Institute of Actuaries, *it is very questionable if it would have been so vigorous, or so surely founded as it is at the present day if it had depended, at its inception, on assistance or support in any form from the State*." (author's own italics). Interestingly, Nicoll then went on to compare the system in the U.K. with that in the United States of America.

It was suggested that the position of the actuary there had been damaged by official valuations. That system of official valuations had a result which no-one would have expected. Despite the fact that the official valuation was done on a wholly arbitrary basis, it became the standard for all public comparisons, with the actuary's own valuations being ignored.

6.15 Thus the actuarial profession, on this limited evidence, does appear to have arisen as a spontaneous product of the market, and the alternative of statutory regulation could be regarded as having displaced a market structure in the U.S.A. which could have achieved the same purpose more effectively. As we shall see later, the actuarial profession has also developed to serve different purposes, which are of value to market participants. The point of a market order, as opposed to a regulated order, is that the results cannot be known to anybody in advance, but it is known that it will serve participants better than a regulated order could. It could be said of the Institute of Actuaries that, "The decisive effects that led to the creation of the order itself and to certain practices predominating over others, were exceedingly remote results of what earlier individuals had done, results exerting themselves on groups of which earlier individuals could hardly have been aware" (Hayek, 1988, page 72, discussing the development of markets in general). As well as providing educated and trained expertise, of value to companies and ultimately to consumers, the profession has developed a sophisticated mechanism of professional standards which are of value to the consumer in providing trust and security in an industry which is characterised by the problems which were described by Nicoll (1898), as discussed in Section 4. The Austrian philosophy suggests that the mechanisms necessary to fulfil these consumer needs could not have been predicted, and, therefore, could not have been developed as effectively by regulation.

6.16 The actuarial profession has changed in nature, although not significantly in purpose, over the last 100 years. It has developed professional guidance, a code of conduct and examination standards. It would still appear to be a spontaneous product of the market, which has evolved to meet the special problems, relating to the financial services industry, that were identified by the 1853 Select Committee. The profession is sustained because the professional can be more highly remunerated, because it is of value to companies to be seen to be employing people who, in the event of a conflict between commercial interest and the interests of policyholders, will have a professional duty to look after the interests of policyholders. The market structure passes price signals, which reflect consumers' preferences for security, through the market to the members of the professional body, who can gain from developing constitutional structures which satisfy those consumer preferences. Companies then benefit from demonstrating that they are employing people from a professional body, which requires that its members give advice in accordance with certain principles. One example of how the actuary is now obliged to carry out his responsibilities can be found from the Guidance Notes and Code of Professional Conduct. In Guidance Note 1 (1996), it is stated, "The profession's rules of conduct make clear that every actuary,

whether remunerated by salary or fee, has a duty to the profession and an individual's responsibility to the client must be consistent with this." (¶3.1). The Guidance Note further advises that the Appointed Actuary of a life company must advise the Department of Trade and Industry if a company fails to take the advised action if there is a material risk that the long-term fund will be insufficient to meet the liabilities. However, the major role of the professional body is probably not in the direct protection of the beneficiaries of the fund, where there is a conflict of interest, but in ensuring that competent methods are used when giving actuarial advice. Such competence is encouraged by the Code of Conduct, the Guidance Notes, the examinations system and continuing professional development. One should also not assume that the way in which actuaries should act in particular situations should always be codified. It is possibly more important for the profession to develop general standards of competence and judgement. It is not possible, according to Austrian principles, to determine, in advance, the exact course of action which should be taken in particular circumstances. One of the problems of regulation, seen most obviously in the regulation arising from the Financial Services Act 1986 and the Pensions Act 1995, is that it tries to lay down exactly how market participants should behave in particular circumstances. For many years the professional responsibilities of the actuary were not codified. This did not necessarily make actuaries less effective in discharging their responsibilities. The Institute and the Faculty of Actuaries, products of the market, have, instead, merely dictated the principles which should be followed. The dangers of codifying practice too much are discussed in Myddelton (1995). Some of the codes of conduct developed by the profession would also appear to have been effectively imposed or sanctioned by government (Guidance Note 27 being an example); these cannot be regarded as spontaneous developments in response to the needs of the market. One should also not confuse the development of professional standards and industry codes of conduct with what has now become known as self-regulation. Self-regulation, as practised under the Financial Services Act, is not a spontaneous product of the market; it is closer to government contracting out statutory regulatory functions to the private sector.

6.17 Other structures of the market, which have developed to protect consumers in an area where products are complex, are the mutual insurance company and the friendly society (building societies may be an even more significant example). Prima facie, mutuals may seem inefficient. They may use capital inefficiently. They often operate below the optimal scale for the industry. Ownership and control are more divorced than in a proprietary company (leading to some of the inefficiencies described in Section 4). Major mutual companies are still important today, although friendly societies have declined in relative terms since the nationalisation of social insurance. The success of friendly societies in the early part of the century is discussed in Seldon (1996). At the beginning of the 1950s there were 14 million accounts with industrial societies, co-operative societies and provident institutions, and over 8 million policies held with friendly

societies. It is no easier to determine what drove the development of friendly societies *ex post* than it would have been to predict their development *ex ante*. One plausible explanation is that members (who were often not sophisticated financially) felt more secure with an organisation which could not be run against the interests of the policyholders for the benefit of shareholders (although it could be possible for management to capture a society). The mutual institutions and friendly societies may well have been sophisticated developments in the market which evolved for the benefit of those requiring protection from risk.

6.18 A final example, which is worth mentioning, is the development of intermediary markets and information sources for consumers (personal finance magazines, etc.). These are a further examples of structures and products which can develop in a market and which will reduce the risk to the consumer of long-term financial services. Intermediaries provide an independent and informed (although self-interested) source of analysis, advice and information for consumers, who may be unable to analyse the information produced by companies themselves.

6.19 Thus, Austrians suggest that a sophisticated extended order may need to develop, and can develop, in markets selling complex products. This extended order would include professional bodies, special types of company organisation and intermediaries which will satisfy the needs of consumers. The particular form that those institutions may take will not be predictable in advance, and sometimes they may seem irrational or inefficient, even *ex post*. The market institutions will be more effective than regulation in ensuring that consumer demands are met, because it is not possible for regulators to know the detailed effects of the rules that they develop, nor is it possible for them to centralise the knowledge about the risk profiles of consumers. In addition, regulators may also act in their own best interest. The author believes that there is prima facie evidence that an extended order has evolved which has satisfied the needs of consumers for risk protection, in the absence of detailed regulation, in the period between 1850 and 1982.

6.20 Some international comparisons are worthwhile. (See also ¶6.14.) Ferguson *et al.* (1989) summarised the development of financial services markets and regulatory systems in the E.U. It was suggested that, in those markets with a rigid regulatory regime, the risk to the consumer was lower, but this was largely because product variety was less (consumers were unable to buy risky products which were effectively limited by regulation). Also, actuarial professions and other mechanisms of protection, such as industry codes of practice, had not developed to the same extent as in the U.K. It does appear that, without regulation, market signals will be transmitted so that structures in the market can develop to protect the interest of consumers. An interesting example, which illustrates how the market can evolve to meet consumer need, but also how regulation can be captured, is given in Simpson (1996). In response to the deregulation of financial services in Germany, the professional body representing intermediaries set up a training and examination programme. The German

government decided not to take any further steps in developing regulation. However, the German industry wanted its own training and examination system to be given the force of law, in order to restrict competition.

6.21 Thus, if the market has appeared to evolve in a way which is not inconsistent with Austrian principles, has regulation been along the lines which would be accepted by Austrians as being reasonable? The principles which the Austrian School believe should underpin law are discussed in great detail in Hayek (1982). Here it is only possible to outline some of the relevant tenets. They are not essentially much different from classical principles of law; however, they have a foundation based also in economics. Firstly, rules should be based on general principles and be 'abstract'; in legal terms this means that the rules should be applicable to unknown people in an unknown number of instances (for example, rules requiring intermediaries to indicate the range of products on which they could give advice would pass this test; rules prohibiting intermediaries who could not give advice on a full range of products from practising would not).

6.22 Secondly, detailed rules requiring particular behaviour or methods of analysis in particular circumstances are undesirable; it is not possible for the legislator to predict, in advance, what course of action is desirable in particular circumstances and what the unforeseen consequences will be of requiring particular types of action. Furthermore, it is recognised that a free contract between two individuals will generally be to the benefit of both individuals. Therefore, detailed rules should not prohibit particular types of behaviour or contracts, but ensure fair enforceability of contracts freely entered and promote competition, so that a consumer cannot be said to be acting in a particular way because he does not have genuine free choice.

6.23 Thirdly, arbitrary power should not generally be given to officials or politicians to create more rules without reference to the legislature, or enforce rules without reference to courts; if such power is given, it could be abused without proper accountability, and officials could cause a proliferation of rules which could undermine the market and, indeed, undermine the whole basis of a free society.

6.24 Fourthly, it is not possible for a regulator to foresee what market structure will best serve the unknown and constantly changing needs of market participants; it is, therefore, unwise to impose a particular structure on a market or business organisation (rules preventing the development of monopoly power are often accepted as reasonable, as competition is essential for the working of the market).

6.25 Finally, law would not normally be regarded as desirable if its purpose was merely to try to perfect identified imperfections in a market or if it would undermine the structures of the market which provided the incentives for people to learn from their mistakes. This latter point is quite important, because legislation is often justified because of a particular, unforeseeable event (such as the Maxwell affair). Such legislation identifies the way in which the market has failed, but, in attempting to ensure the market does not fail in that way again, it

may undermine the very structures which allow the market to learn from the event. There may then be further failure, because people stop responding to market signals, and more regulation then seems to be required.

6.26 We will now consider a few important pieces of legislation affecting insurers and pension funds, and see whether they have deviated from the principles outlined above. The main purpose of the Life Assurance Companies Act 1870 was to ensure that companies made their affairs public. This is not something which would conflict with an Austrian framework for regulation. The Act would apply without any obvious discrimination against particular types of company (it would be 'abstract'). It did not involve detailed regulation. It supported, rather than conflicted with, the role of the market; it recognised that there was an information deficiency in the market, so that the market may be prevented from performing its proper role, and it corrected that deficiency. The Act did not even determine the basis on which information would be produced. It allowed the market to develop its own structures for interpreting information.

6.27 Much later regulation was influenced by U.K. membership of the European Economic Community (later E.U.). The Appointed Actuary system (which was not influenced by the E.E.C.) has already been discussed, and it is no more clear whether this deviates from Austrian principles than it is clear whether it deviates from public interest principles. In the author's view, it is not a significant deviation from Austrian principles. However, the Insurance Companies Act 1982 was much more wide ranging than any previous regulation. It is a good example of how, when one breaches one principle of law, the others can be endangered. The Insurance Companies Act 1982 most clearly breaches the second principle, in that detailed rules are enforced, dictating particular behaviour in particular circumstances (the actuary is instructed how to do a published valuation, and the company instructed as to the minimum solvency margins it must hold). Very detailed information, calculated in a particular way, has to be deposited with the Department of Trade and Industry. The market is prevented from developing its own solution to the difficult problem of how to ensure that consumers are properly informed about companies with which they do business; also, an issue about which there is a considerable amount of subjectivity is given a false air of objectivity. This apparent objectivity removes some of the responsibility from the consumer to ascertain (perhaps by referring to intermediaries or to publications) the financial position of an insurer. It, therefore, impedes the learning process of the market, thus breaching the fifth principle. Also, because the regulations are so arbitrary, their enforcement is arbitrary. Furthermore, power has been given to politicians, under the Act, to develop more rules of the same type without proper reference to Parliament. One originally unforeseen effect is that the Act probably also breaches the first principle of law (see ¶6.1). At first sight, the rules appear to treat different companies equally. However, it is becoming increasingly clear that this is no longer the case. To give one example, if equity values fell, a company with a high equity backing ratio for with-profits policies may appear insolvent, but could return to an apparently

solvent position again by selling equities and buying fixed-interest securities of the same value. This arises because the regulation requires that the valuation rate of interest is determined with reference to objective concepts (the rate of return from fixed-interest securities and the running yield from equities), when the rate of return which will be earned on assets over the term of the liabilities is intrinsically a subjective concept.

6.28 The Financial Services Act 1986 and the Pensions Act 1995 would appear to breach classical and Austrian legal principles. It is worth mentioning a few examples. The Financial Services Act mainly deals with the sale of financial services. Rather than trying to follow Austrian principles of developing general principles of law which support the market in its role, the Act developed very detailed regulation and, more importantly, regulatory structures, which restricted the market. There are a number of examples of deviation from Austrian principles of law. Regarding the development of very detailed rules about the method of sale of a product, the detailed rules which have been prescribed, may well prohibit valuable economic transactions, by raising both the time and transaction costs of small premium business (and make those transactions which do take place more costly). There is arbitrariness in the system, in that it may be possible for an intermediary to act in accordance with what he or she believes to be the law and associated regulations at the time, and then find, retrospectively, that action will be taken against him or her. There also appears to be an authority, vested in the self regulatory organisations, to proliferate rules with little accountability. The Financial Services Act is an example of a government trying to perfect a market. Rather than work with the market, in supporting its functions, for example by trying to correct the deficiencies in information provision to consumers, it has imposed on the market particular practices, which the regulators believe should be followed, in order to achieve the same outcome that perfect competition would achieve. Unfortunately, it is impossible for regulators to know exactly the practices which would be followed in a perfect market; such a market cannot be simulated by regulation because, in the Austrian view, the necessary information cannot be centralised within the regulatory body. The Financial Services Act stops the market from evolving good selling practice naturally, and makes it more difficult for intermediaries who sell a range of products offering independent advice; in fact outlawing such intermediaries where they do not offer advice on all companies' products. As MacGregor (1996) has pointed out, the principle of *caveat emptor* is also violated by the Act, in that people do not take responsibility for their own mistakes. The learning process on behalf of the customer and the ability of customers to take decisions for themselves in the field of financial services may then stop developing. It appears that the PIA has recognised this point. It has recently suggested that the concept of 'investor protection' may be an unhelpful one, because it indicates to consumers that they might be protected from risk and that they need to be protected from market practices, when, in fact, the market, if working well, will work in the interests of consumers; see Simpson (1996). It should be mentioned that a paternalist aspect

to legislation may be necessary, where politicians deem that the learning process takes too long to be politically sustainable, leading to financial scandals. However, it is important to appreciate that the market does, in fact, develop by learning from mistakes.

6.29 The Pensions Act 1995 makes many similar mistakes, in the Austrian view. We will consider just the minimum funding requirement. Rather than requiring disclosure of a funding position and allowing the market to develop the best way to calculate that, a particular set of detailed calculations has been prescribed by law. The market, left free to evolve, has required that, in most cases, the funding level of a scheme was determined in accordance with a set of principles, possibly by an individual with a demonstrated level of competence. Instead, the state has tried to prescribe the detailed calculations that should be carried out, as if these should be the same in every case and as if it is possible for the state to determine what they should be. Significant arbitrary power has been given to the Secretary of State to develop further rules without full reference to Parliament. The Secretary of State, effectively, has to approve Institute and Faculty of Actuaries' guidance on the matter, such guidance effectively becoming extensions of the detailed statutory regulation. The Pensions Act arose, to an extent, from popular demand after the Maxwell affair. It does appear to be an attempt to prevent that particular event happening again, rather than supporting the structures of the market which allow the market to learn quickly from its mistakes.

7. CONCLUSIONS

7.1 In this section conclusions are drawn and principles of regulation are developed which, if followed, would not conflict with the Austrian school's view of regulation. Many of these principles would also address the concerns of the public choice school.

7.2 Market socialism and the Austrian school can be regarded as being at the opposite ends of the philosophical spectrum. Market socialists believe that all the information necessary for taking economic decisions can be centralised. Through central direction, it is, therefore, possible to organise productive processes to maximise economic welfare. The insurance market would, therefore, be controlled, in all its aspects, by the state. Neo-classical economics challenges the view that resources are best allocated and controlled by the state, and would suggest that a free market and the process of competition would best ensure that consumers' needs are met. However, markets have imperfections, and the traditional form of regulation of insurance in the U.K. ('freedom with publicity') attempts to remedy one particular imperfection: there may be a market failure in the provision of information, and the state can then improve the workings of the market by regulating insurance companies so that they have to provide a certain amount of information to the consumer.

7.3 'Freedom with publicity' implies the development of a distinct, abstract

legal framework which does not involve, to any significant extent, controls on the actions of market participants. The degree of intervention is also limited to one particular aspect of possible market failure. Public interest theory proposes that there can be a body of benevolent regulators which can correct a number of imperfections in markets through regulation. However, public choice theory suggests that regulators are neither necessarily benevolent and, additionally, they are not farsighted enough to be able to see all the implications of their actions; just as the market can fail, regulators can also fail. Public choice theory predicts that there will be an over supply of regulation (because of the interests of those supplying it), and that regulation, even by benevolent regulators, will not necessarily improve the workings of the market (because it is impossible for the regulators to see all the implications of regulation).

7.4 Austrian economists would draw many of the same conclusions as public choice theorists. The former would emphasise the market as the mechanism which best gathers and uses all available information about consumer choice, preferences, costs of production, etc. Austrians would believe that it is not reasonable, as proponents of public interest suggest, to try to correct every deficiency in the market. The market has a self-correcting mechanism, and regulation should be developed which works with this. Markets operating in a broad framework of abstract rules will produce a better outcome than central direction through regulation. In the Austrian view, where regulation does exist, it should be abstract and not arbitrary. It should concentrate on laying down the framework within which people should act, rather than on directing particular actions. Arbitrary power should not be given to regulatory authorities, because there may then be no control on how that power is used, and consumers and producers would not be able to act in a stable framework.

7.5 The models of economic behaviour which have been described are not merely of academic interest. If a model of economic behaviour is accepted which does not take into account the essential features of human behaviour, the wrong regulatory system could be chosen; this could seriously affect economic welfare. For example, if the behaviour of bureaucrats were not taken into account (if the public interest model were chosen instead of the public choice model, in a world where the public choice model is more complete), systems could be set up which would gradually erode the efficiency of the market. Evidence has been put forward which suggests that the Austrian framework should be considered as an alternative to the public choice framework. What principles of regulation would be compatible with such a view? The most basic principles of law, which have underpinned trade and commerce in the U.K., for much of the period from the 18th century to the beginning of the 1970s, are, in fact, quite compatible with the Austrian framework. If regulation returned to such a framework, the emphasis would be on: enforcement of contracts; the protection against fraud and misrepresentation; disclosure and the promotion of competition. Enforcement of contracts and protection against fraud are essential to provide a stable framework within which market participants can operate. A response to the Maxwell crisis

could, for example, have emphasised the importance of the separation of the interests of trustees and the company management. In the Austrian view, disclosure of information would be more appropriate than prescribing particular selling procedures. In the context of life insurance regulation, a published valuation, on a basis determined by the actuary, would be more appropriate than a published valuation on a particular basis. The aim should not be to provide information which the public can necessarily understand, but provide a framework within which information is provided, which can then be interpreted and explained by other institutions in the market.

7.6 An issue of particular interest to the actuarial profession is the certification of competence of professionals, and whether there should be statutory roles for such certified professionals. It is possible that certification systems may provide a way of ensuring high standards in a market for complex products. However, this does not mean that the government either has to administer the process of certification or exclude from practise those who are not certificated. In Section 6 we have already discussed a possible economic justification for professions which have, historically, performed the role of certifying people who are competent to perform particular tasks and who, historically, 'professed' an oath which indicated a degree of trustworthiness and detachment from commercial interest. Because consumers value such attributes, the market can develop systems which provide them. In the author's view, it does not considerably undermine the market mechanism if the government imposes a certification process, as it does through the Appointed Actuary system. However, if the government were to control the qualification, or if the statutory duties of the actuary came to be a considerable proportion of the profession's work, it would change the nature of the profession and undermine the market mechanism which led the profession to come into being, and which, according to the Austrian thesis, is more likely to anticipate and deal with consumers' needs, by the development of complex structures than detailed regulation will.

7.7 Thus, if the Austrian model is correct, the market will not develop to meet consumers' needs unless regulation returns to its traditional form. This would mean replacing some of the arbitrary power of regulators and the detailed rules of how market participants should behave in particular circumstances. It does not mean, however, that all types of regulation or that all regulatory structures are inappropriate. Public choice theory would make similar predictions, although for different reasons. There may also be some lessons for the profession. It has been argued that the professions in the U.K. have been an important structure, as a spontaneous product of the market, in helping to protect the consumer interest in a complex market, in a framework which is adaptable to changes in consumers' needs, in a way in which regulation often cannot be. It has also been argued that the ends of the economic process are rarely known to those who take economic decisions. The actuarial profession has, therefore, had to change, evolve and adapt to achieve ends which are constantly changing, but which are never known with absolute clarity. This process will continue, and is

likely to be by a constant process of trial and error and innovation rather than by radical change. Statutory roles may be appropriate, but they are not the *raison d'être* of the profession.

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