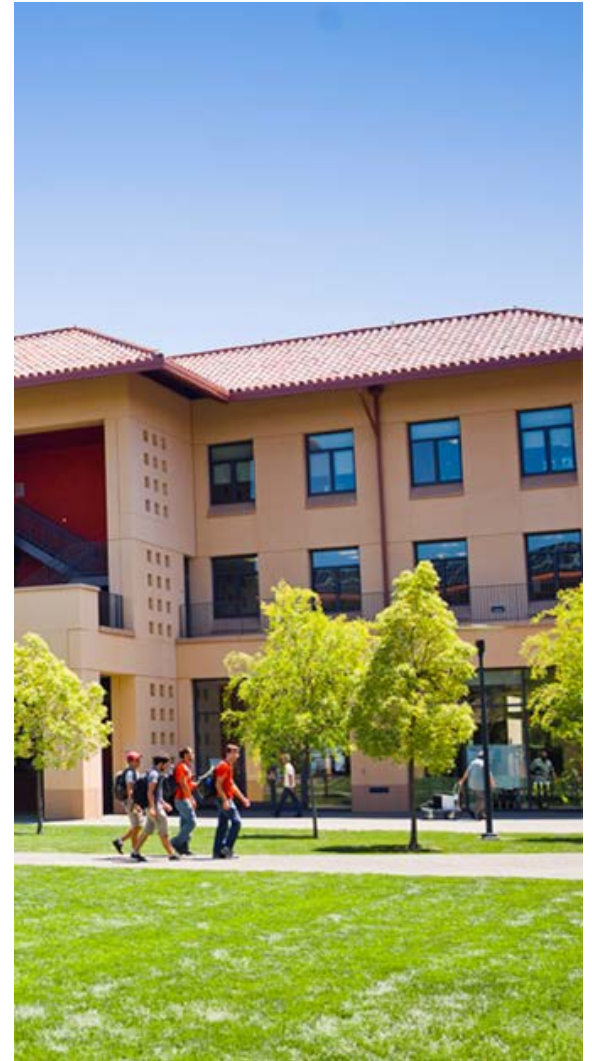


# Managing the Human Resources of Regulators (and other civil servants)

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# Why am I speaking

- I'm a "tag-along"
- I'm also an economist, so the organizers asked me to speak
- I'm an economic theorist with interests specifically in human resource management (HRM), using both economics and social psychology
- So the reason for this topic: my comparative advantage

## Hence the following caveats

- Principle #1 for practicing HRM: *You **must** know the details!*
- But concerning regulators and regulation as a profession, I don't (except for what I read in the papers, etc.)
- My aim: Be provocative
- My fear: This will just be silly
- My hope: Provocative or silly, to spark a conversation

# A conversation about...

...managing the human resources of regulators to prevent or, at least, ameliorate **regulatory capture**

Bottom line:

- There are some possibly paths one could take (and I doubt I'm original on any of them)
- But there is a prerequisite condition, which is hard to satisfy
- This is the start of a long and complex conversation

# Step 1: Do we need regulation at all? Why?

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In any audit of (with a view toward improving) HRM at an organization, first answer the following questions:

1. What is the **business strategy** of the organization?
2. What **behaviors** by the (particular class of) employee (being studied) will **advance** that strategy?

In this context

1. Why do we **want to regulate** whatever it is that is being regulated? What **purpose** is served?
2. What sort of **decisions/actions** by the regulators are **desired**?

# Step 1: Do we need regulation at all? Why?

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Not fatuous questions:

Quote by a reputedly sensible colleague of mine:

“If you want the regulators to do the right thing, shouldn’t it always be to close up shop? Isn’t regulation almost always the result of some party or other seeking to extract rents?”

Step 1: Clarify the **social purpose of regulation**

- **controlling externalities** whether pecuniary, physical, or informational;
- **engaging in equitable redistribution**

Is there political consensus? (This is important...wait for it)

# Step 1: Do we need regulation at all? Why?

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Probably **no political consensus**, which later will be critical

But for now, I **assume**

1. a **clear** (and socially beneficial) **purpose** for regulation exists,
2. **society generally agrees** on this, and
3. a solid and persuasive **intellectual case** in favor of that purpose **can be mounted**

## Step 2: In whose interest?

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Once the public interest in regulation is fixed, can ask:

*In whose interest do the regulators regulate?*

- 1. The public:** what was assumed to exist last slide
- 2. The parties being regulated,** through the process of **regulatory capture**

(This is not a complete list---more possibilities are coming later)



# 3 varieties of regulatory capture

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Why would regulators be “captured” by the organizations they are meant to regulate?

- 1. Economic incentives:** The revolving door and rewards by the industry for “behaving” while a regulator
- 2. Intellectual capture:** Regulated organizations and their “friends” in academia & the press make a case that regulators “ought” to act in the interests of those being regulated
- 3. Social capture:** By associating with individuals from the regulated organizations, internalizing the welfare/desiring the good regard of those being regulated and then serving their interests

# 3 varieties of regulatory capture

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All three

- 1. Economic incentives**
- 2. Intellectual capture**
- 3. Social capture**

are at work.

A solid HRM design to foil capture must deal with all three

# Dealing with economic incentives

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Blunting the economic incentives is, in theory, easiest. Use a mix of “carrot” and “stick”

**Stick #1: Regulate “by rule”** (e.g., Averch-Johnson rate-of-return regulation; no under-the-table money) and **vigorously enforce compliance** (Singapore Civil Service and Peter Ong Boon Kwee)

**Stick #2: Close the revolving door by legal agreement:** At some point in the life of young regulator, if they want to advance in the regulatory hierarchy, they sign a binding agreement never (or for some length of time) to work in the industry they are regulating

# Will courts enforce you-can't-work agreements?

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(Not speaking here of from-industry-to-government moves; that is, the “reverse revolving door.” That comes later.)

Evidence in the US is inconclusive.

1. Non-compete agreements of limited duration are generally enforceable.
2. Also, restrictions on lobbying activities after government service are on the books (even if waivers are too frequently granted).
3. Legislation strengthening the restrictions on government-to-industry moves have been proposed in the US, but do not seem to be getting anywhere

And even if such legislation is enforceable within a country, in any industry populated with global firms, how do you enforce such laws internationally?

# So how about trying a “carrot” approach?

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## Compensation levels should match those earned in the industry regulated

Today, at least in the US, compensation for government service is FAR below what individuals can earn elsewhere

Who takes jobs with the government?

- Already rich
- Want to get “experience” so later they can cash in

Certainly true of the political class, but also civil servants

Colleague (speaking not for attribution): “Service in XXX (bank regulation) is often undertaken as a **career step** into the banking industry”

# The “carrot” approach

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**Compensation levels should match those earned in the industry regulated**

Politically feasible? Pay a senior regulator far in excess of what is paid to a member of the national legislature? (Pay members of the legislature more?)

Hard to convince the electorate that employment in the public sector should pay better than employment in the private sector

Good subject matter for populist demagoguery

# The “carrot” approach?

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## Compensation levels to match those earned in the industry regulated

Two possible compensation “tricks”

1. Move the calculation from ex post matching of income to ex ante (expected) compensation
  - But depends on enforcing can't-work regulations, especially given the huge rewards for folks in the financial sector
2. Enlist forms of “golden-handcuffs”: Delayed compensation, very generous pension provisions that disappear if the individual moves to the industry he/she regulated.

## Other economic incentive items

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Not necessarily tied to closing the revolving door, but regulated industries use economic incentives to corrupt the system in other ways

Morgenstern and Rosner, *Reckless Endangerment*:

Fannie-Mae (government-sponsored enterprise in US dealing in mortgages, with government guarantees to the lenders)

1. Got jobs for friends and relatives of officials
2. Commissioned work by “neutral” academics
3. Made donations to organizations that had (before the donation) been asking for tighter regulation
4. And, of course, made large political contributions to politicians on both sides



# Economic “rent” potential explains a lot

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John Taylor and Frank Wolak, “A Comparison of Government Regulation of Risk in the Financial Services and Nuclear Power Industries,” Hoover Institution Discussion Paper, 2011

Find that regulation of risk much more effective for Nuclear Power Industries than for Financial Services

Give a variety of structural explanations

But one (in particular) stands out: **The potential stakes for industry participants, and the largesse they can deliver to get their way, is so much higher in Financial Services**

# Intellectual capture

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Regulators must be armed with a clear and robust story of what they are aiming for and why, and with the ability to argue away competing stories put forward by the industry and their allies

Requires base-level education, in the relevant social sciences (especially, but not limited to, economics)

Often requires more specialized & up-to-date knowledge, as well the regulated parties “evolve”

Someone trained in the “basics” of financial sector regulation in the 1970s would have a very hard time in the 2000s dealing with the changed environment

**Hence requires base level *and* continuing education**

# The military analogy

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A good---not perfect---analogy comes from the armed services

Officers need basic education and continuing & advanced education

Basic education provided to officers in **service academies**

Continuing education provided in “**advanced training**” **facilities** such as the US Army War College, General Staff College

Some of this is outsourced---sending officers to do graduate studies, on subjects that are not in the military’s comparative advantage

# A service academy & more for civil servants?

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Perhaps: (1) **A civil-service academy**, free college education but with a service requirement, for basic training

(2) On-going “advanced training,” keyed to promotion in “rank” in the civil service and/or to assignments in specialized industries

(3) Outsourced training in very specialized subjects (e.g., energy technology; rocket-science finance)

The military starts with leadership, basic combat arms & engineering. Later adds social science.

Civil service probably should reverse the order.

# Borrowed expertise? The reverse revolving door

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At least when it comes to the financial sector, and perhaps other sectors as well, regulators are sometimes “borrowed” from the industry

Rationale: *Only insiders know where all the bodies are buried*

IF (and it is a big IF) movement in this direction is permanent---no going back---then MAYBE from an economic/intellectual perspective this is okay

Although from an intellectual perspective, probably not

And, anyway, movement back to the industry is not blocked: This sort of reverse flow is terrible from the perspective of mitigating capture. It INVITES capture.

## But only insiders know where the bodies are buried...

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To the extent that this is true, regulation must include

- All “graves” are open to inspection
- Regulators need to be kept as up-to-date as possible
- Regulation has to be based more on ex-post verifiable rules, giving less discretion to industry participants

Imposing rules/preventing discretion is economically inefficient---a tradeoff exists here

But this is a tradeoff that favors simplicity/openness in how you regulate, so a hunt for buried bodies is relatively less important to effective regulation

# Allowing industry folks into regulatory positions has another negative effect

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Even if they are effectively barred from returning to the industry...

Phenomenon of **social capture**:

- Regulators identify with the interests of people the industry they are regulating
- Not on any intellectual grounds, but because they “hang with” folks from the regulated industry

Obviously, if the regulators have a past life in the regulated industry, this problem can be severe...

...unless the people picked to enter the regulatory ranks are systematically chosen from whistle-blowers/malcontents (which might not be a completely terrible idea)

# Social capture is a more general problem...

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Even if there is no crossover of individuals

Regulators who interact with the people they regulate; the proverbial “meet on the golf course” or “go out for a drink after work”

Some social interaction is inevitable and, probably, desirable

But to combat social capture, regulators need to have developed an us vs. them mentality

A corps of regulators/civil servants---with esprit de corps developed from Day 1 at the Civil Service Academy, and reinforced with frequent “training reunions” with classmates, could help

And it could develop substantial peer pressure among the civil servants, not to “let the class/corps down”



## An example (recently working less well)

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The French “civil service academy”: Ecole Nationale d’Administration (ENA)

Graduates known as Enarques

Have (historically) formed a very cohesive corps of civil servants, with very strong peer pressure effects

(But, recently, some Enarques have gone through the revolving door. Need to up the shame level for such folks!)

# Lionization of regulated industries is an issue...

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...as is social disdain directed at civil servants

Ideally, civil service should command great status and social respect

This is just compensation in non-monetary form, but compensation that (economic theory notwithstanding) people value

# Self-determination theory should be used...

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A social-psychological theory

Holds that people are motivated by

1. the ability to act with autonomy
2. the opportunity to develop/exhibit competence
3. the opportunity to be socially related to others

If political considerations make it hard to reward civil servants/regulators with salary, these are tools that, used intelligently, can be employed to enhance the motivation of regulators/civil servants to do the right thing

# So, can capture be prevented/diminished?

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First, recognize the different dimensions

Economic capture

Intellectual capture

Social capture

And then, attack all three---by some of the means given above, or by others

However, there are complications not yet touched upon

Illustrated by the history of the British Civil Service over the course of the 20<sup>th</sup> century...

# The British Civil Service ca. 1955

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In history, from the Mandarin system in Imperial China to today, no Civil Service system has been perfect

But the British Civil Service ca. 1955 is probably as good as it gets

- Dealt apolitically and effectively with the major parties
- Recruited from the “best” universities some of the best students
- Those students aspired to lifelong careers in the Civil Service
- Few if any hints of corruption or “capture” by any political interest group

# What made it work?

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A variety of policies and factors

- Policy of pay comparability
- Very high status---being in the civil service---especially being very high in the civil service---had very significant social clout
- Buttressed by the awarding of knighthoods and other decorations, and life peerages to folks at the top
- In British society, being “in commerce” was not particularly high social status---going through the revolving door was a step down socially
- And political interest groups largely lacked the resources to corrupt the system

# But, by 1990, the Civil Service was in disarray

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Several “political” causes

- **Internal focus:** Civil Service increasingly perceived as being in the business of preserving the perks and status and power of the civil service
- Perception that it was populated by “old Etonian” types---not at all representative of the society that it served
- Lack of technical expertise, in a job that increasingly needed strong technical skills

Labour government (Wilson) set out to “modernize” the Civil Service---become more representative, have more technical training

To help secure these “reforms,” removed control from the Treasury to a new Civil Service Department

# And then another wave hit

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The free-market Tories (Ms. Thatcher) felt that the Civil Service was increasingly a tool of the left-wing politics (Labour)

So she sought to hobble them

- Cut ranks by close to 20%
- Abolished pay comparability
- Abolished the Civil Service Department and instead had the Civil Service report to the Prime Minister's Office



## Meanwhile, the environment changed

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Free-market policies and the de-nationalization of many industries put the Civil Service into greater conflict with increasingly powerful and wealthy interest groups

Social status of being “in commerce” rose

What industries could offer “former civil servants” increased---the revolving door began to revolve with a vengeance

# What do we learn from this history?

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Regulatory bodies can look after the interests of the public or the interests of the people they regulate, but there are other possibilities

- Pursue a particular political ideology
- Pursue the interests of the regulatory body itself: Enlarge its power and ensure its (comfortable) survival

Steps taken to prevent industry capture may (unwittingly, but perhaps predictably), enhance capture by another group, other than the public interest

# Go back to Step #1 in any HRM Audit

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In general HRM audits, begin with

1. What is the “business strategy” of the organization?
2. What behaviors by the (particular class of) employee (being studied) will advance that strategy?

In the context of regulatory bodies

1. Why do we **want to regulate** whatever it is that is being regulated? What **purpose** is served?
2. What sort of **decisions/actions** by the regulators are **desired**?

# Go back to Step #1 in any HRM Audit

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In the for-profit business context, the questions

1. What is the “business strategy” of the organization?
2. What behaviors by the (particular class of) employee (being studied) will advance that strategy?

Have settled answers, more or less, set by top management.

The answers given by top management may be unwise, but in well-run organizations, there is (should be?) a common understanding what are the answers.

# Go back to Step #1 in any HRM Audit

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But, in the context of regulation, the questions are

1. Why do we **want to regulate** whatever it is that is being regulated? What **purpose** is served?
2. What sort of **decisions/actions** by the regulators are **desired**?

And where these answers are politically contentious or unsettled, this gives the regulated bodies room to play one side of the debate off against the other.

# If you want to stop/minimize regulatory capture

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The first and essential step is

## Find a social consensus on answers to the questions

1. Why do we **want to regulate** whatever it is that is being regulated? What **purpose** is served?
2. What sort of **decisions/actions** by the regulators are **desired**?

Probably unwise in the long run for political forces to use regulators to advance their political agenda---keep it to things on which there is relative consensus

**If you can, there are possible courses of action you can take to minimize capture.**

**If you cannot, Good luck.**