Creating Competitive Markets

THE POLITICS OF REGULATORY REFORM

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Why Freer Markets Need More Rules

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According to many political economy scholars, modern market systems are not natural phenomena that arise spontaneously but complex institutions that must be created and sustained by the visible hand of the government. Scholars apply this precept to three types of market transitions: from feudalism to market society in the West, from communism to capitalism in Eastern Europe and East Asia, and from poorly developed to viable market systems in developing countries.[1] For the most part, however, they have not applied it to the more subtle transition toward more competitive market systems in the advanced industrial countries. But if markets are institutions, market reform should consist of building institutions more than of removing constraints, and this principle should apply to more developed market systems as much as to less developed ones.

There is no controversy on this point in its most stripped-down form: namely, that markets are institutions. Yet scholars diverge considerably in what they mean by this. Classic liberals acknowledge that the government must establish and enforce basic property rights; design the essential infrastructure for a modern economy, such as a monetary system; and provide

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certain public goods, such as national defense.[2] Institutional economists identify a much broader range of market institutions, including the modern corporation, corporate governance systems, and long-term business contracts. They view transaction costs (such as information and enforcement costs) as the "friction" in the market system and property rights, broadly defined, as the institutional mechanisms for reducing these transaction costs.[3] Economic sociologists define market institutions even more broadly, including social networks and market cultures. They emphasize that market systems are inherently embedded in society itself, not only in formal structures but also in standard practices and social norms.[4]

Markets as Institutions: Some Implications

If markets are institutions, this quickly leads to some rather profound implications for market reform in the advanced industrial countries, both in theory and in practice. I use the term "market reform" here to refer to a wide range of measures that enhance the role of markets in society.

1. *There are no "free" markets.* Economists often assume perfect markets for the purposes of devising a model or making an argument, and there is nothing inherently wrong with that. They have made some of their greatest theoretical breakthroughs and presented some of their most useful prescriptions through precisely this sort of simplifying assumption. But one should not forget that these frictionless markets—in which buyers and sellers are seamlessly matched without any transaction costs whatsoever—do not really exist. In the most basic case of two people exchanging goods, the rules governing their transactions may be very simple. In real-life market systems in advanced industrial countries, however, the institutions that structure markets are extremely complex. They consist of intricate networks of laws, practices, and norms. This first point may not be particularly controversial in itself, but it logically leads to the following propositions, which challenge the prevailing discourse on the relationship between governments and markets.

2. *There is no such thing as a disembedded or even a less embedded market system.* Scholars have developed various typologies to identify the varieties of national market systems, such as liberal market economies versus coordinated market economies.[5] Some of these designations imply that liberal market systems are less embedded in politics and society than other systems.[6] Yet an American-style liberal market economy is not disembedded from society, nor is it even less embedded than a Japanese-style coordinated market economy.

An American-style external labor market, for example, is not any less embedded than a Japanese-style internal labor market, an American equity-based financial system is not any less embedded than a Japanese credit-based system, and an American antitrust regime is not any less embedded than a Japanese corporate network (*keiretsu*). That is, an American-style liberal market economy is embedded in its own specific matrix of policies, practices, and norms. The Japanese labor market, for example, is embedded in a political-economic system in which government policies discourage labor mobility, large firms favor new graduates over midcareer hires, employees are reluctant to defect from large firms to their competitors, and social norms place a premium on employment stability and employee loyalty. But the American labor market is embedded in its own system, in which government policies encourage labor mobility, firms embrace midcareer hires, employees commonly defect to competitors, and prevailing norms encourage firms to lay off workers and employees to offer their services to the highest bidder.

3. *Market reform involves changes at every level of a political-economic system: government policies, private sector practices, and social norms.* Most scholars focus on government policy as the primary locus of the market reform process. This is natural, for government policy is the component of a market system that is most amenable to conscious reform. But one must keep in mind that government policy affects market outcomes only in *interaction* with private sector behavior. The government might liberalize a particular sector, for example, but this does not automatically mean new entrants will emerge or firms will begin to compete on price. Economists differ on whether they view competition as more fragile or more robust, and this in turn affects their views on how far the government must go to generate competition. As Adam Smith himself attests, most businessmen would prefer the comfort of collusion over the challenge of competition.[7] So in many cases businesses must not only be allowed to compete but also be forced to do so.

Even if one accepts that individuals and businesses do have some natural propensity to engage in market activity (without the government forcing them to do so), social relations and prevalent norms still shape *how* they do so. For example, policymakers might give employers greater flexibility to dismiss workers, but this policy change may not result in more competitive labor markets if managers decide not to resort to dismissals because of the nature of their relations with workers or broader societal norms.

4. *The regulation-versus-competition dichotomy that animates most debates about market reform is fundamentally misleading.* The conventional use of the term "deregulation" reflects this misperception, referring to less regulation

and more competition, as if these two developments were naturally associated. In fact, generating more competition usually requires more regulation, not less. Thus the dominant trend in advanced industrial countries has not been one of deregulation (less regulation), but rather liberalization (more competition) combined with re-regulation (more regulation)—or "freer markets and more rules."

That is to say, whereas popular discourse presupposes a negative relationship between regulation and competition, it is actually more positive than negative. More precisely, it varies across time and across sectors and subsectors. It may be more positive at an early stage, when the government has to create the basic infrastructure to support market competition, and more negative at a later stage, when an incremental increase in the government's role would be more likely to impede than to enhance competition. Or it may be more positive in sectors that are particularly conducive to monopoly (network industries) and more negative in sectors where competition is more likely to evolve naturally (retail). In reality, of course, the relationship is even more complex than this. Some regulations enhance competition, while others impede it. The process of liberalization consists of increasing regulations that enhance competition, such as antitrust rules, and removing regulations that impede it, such as price and entry restrictions. Yet the story does not end there: policies that enhance competition are almost always accompanied by corollary regulations designed to facilitate the competition (as with financial disclosure requirements), protect society from negative side effects (as with environmental regulations), or compensate the potential losers from these policies (as with welfare policies).

5. *The government-versus-market dichotomy that animates most debates about economic policy is also misleading.* As one moves from a thin definition of market institutions (the minimal rules of the game) to a thicker one (a broad range of laws, practices, and norms), the relationship between government and market becomes more positive and less negative. This is not simply because competition requires regulation (as point 4 indicates), but because market competition is not incompatible with a substantial government role in the marketplace beyond that of a referee. The government is the largest consumer, employer, lender or borrower, insurer, and property owner in market economies.[8] Moreover, the government can still manipulate the terms of competition to favor certain marketplace outcomes even if it allows or promotes competition.

Pushing this argument further would require refining language to differentiate between the government's role in creating and sustaining markets and

its role in impeding or crowding out markets. The more common analytical distinctions in the literature—such as the government as a referee versus the government as a player, passive regulation versus active intervention, or setting the rules versus shaping outcomes—provide a useful start, but they do not settle the issue. Indeed, all governments are by definition market players as well as referees, all passive regulation entails some active intervention, and all rule setting has some ramifications for outcomes.

6. *Market reform is primarily a creative process, not a destructive one.* Given points 4 and 5, market reform implies not the dismantling of institutions that impede competition so much as the creation of institutions that sustain it. One cannot simply get the government out of the way and expect greater competition to arise naturally. As already mentioned, scholars have gone further in fleshing out the implications of this principle for transitional economies and developing countries than for advanced industrial countries. If market reform is considered a negative process, then shifting from a command economy to a market system should be easy: just dismantle the command system and let markets flourish. Fostering markets in developing countries should be equally straightforward: just get interventionist governments to back off, and then markets will take over. If market development is considered a constructive project, however, the transition will entail a complex process of building new market institutions. In the next section, I apply this basic logic to the more subtle transition involved in market reform in advanced countries via an extended example from Japan.

How to Make a Market: Evidence from Japan

The debates over market transition in post-communist and developing countries boil down to a simple question relevant to all countries: how does a society make a market? These cases are especially illuminating because the countries are attempting a wholesale transition from planned to market economies or from primitive markets to a functioning national market system. Yet the same insights apply to advanced industrial countries that already have market systems but are attempting a more modest transition toward significantly enhanced markets.

The United States and other advanced industrial economies depend on a market infrastructure—a complex web of government policies, corporate practices, and social norms—that continuously evolves over time. Current-day Japan provides an especially vivid example to illustrate this point, because reformers have been striving to shift the Japanese economic system from a coordinated market architecture to a more liberal one.[9] They have been striving not simply to liberalize specific industrial sectors (via "deregulation," the topic addressed in the next section) but to enhance competition by altering the overall governance of the economic system, including its labor and capital markets.

Japan already has a well-developed legal system that defines and enforces property rights, a modern financial system, and a regulatory bureaucracy. Yet its labor and capital markets differ fundamentally from those of the United States. For example, Japan lacks a "real" labor market in the sense of an active labor market for the core employees of large corporations. Scholars refer to this arrangement as an "internal" labor market, in contrast to the American "external" labor market. What they mean by this is that Japanese companies rotate their core employees across functions, divisions, and locations within the firm or corporate group, but they do not poach employees from competitors, and employees do not defect to competitors. Thus companies do not compete for workers on the basis of wages, and workers do not compete for outside offers.[10]

Likewise, Japan lacks a "real" capital market in the sense of an active market for corporate control.[11] Industrial corporations and banks maintain a substantial proportion of their shares in friendly hands via cross-holdings of shares within business groups, thus insulating firms from the threat of hostile takeover. Although the Japanese government has gradually eased regulations that impede corporate takeovers and introduced policies to facilitate them, the mergers and acquisitions market has only recently begun to emerge—but it is from a very low base compared with that in the United States.

What, then, would it take for Japan to develop a real labor market or a real capital market? This is where the logic of post-communist transition and the creation of market institutions in developing countries outlined earlier can be applied to an advanced industrial economy. From a classical liberal perspective, this should be a relatively simple, primarily negative process, in the sense of removing constraints rather than building institutions. Regulating markets requires hard work, but liberating them should be easy. Since Japan already has a basic system of property rights, then just get the government out of the way, and more active labor and capital markets should emerge spontaneously. From an institutionalist perspective, however, this should be an exceedingly complex, primarily constructive process, in the sense of creating new market institutions and transforming old ones.

To develop a real labor market, the Japanese government would have to remove constraints on employers and nurture the infrastructure for a more

active labor market (see table 2-1). For example, it would have to give employers more flexibility in setting wages, benefits, hours, and working conditions and ease restrictions on hiring nonregular workers, but it would also have to strengthen organizations to match employers with workers and disseminate more information to both employers and workers. In addition, it would have to make changes in areas outside of labor policy itself—including financial regulations, accounting standards, and commercial law—that would encourage firms to be more responsive to shareholders and less beholden to their workers. And it would have to promote portable pension

Table 2-1. *What Would It Take to Turn Japan into a Liberal Market Economy?*

Government policy	*Corporate behavior*
Labor	
Laws	Practices
Labor market reform	Lay off workers when necessary
Changes in case law doctrine	Do not favor new graduates over midcareer hires
Corporate governance reform	Shift from seniority to merit-based pay
Pension reform	Introduce stock options
Financial reform	
Norms	Norms
The government should not use regulation to preserve employment	Companies should not preserve employment at the expense of profits
Net result: an active external labor market	
Finance	
Laws	Practices
Financial reform	Sell off cross-held shares
Banking crisis resolution	Banks make lending decisions and price loans on the basis of risk
Corporate governance reform	Corporations choose banks on the basis of price
Pension reform	Banks stop lending to insolvent firms
Tax reform	
Norms	Norms
The government should not protect banks or manipulate financial markets	Companies should maximize shareholder value
Net result: a market for corporate control	

Source: Steven K. Vogel, *Japan Remodeled: How Government and Industry are Reforming Japanese Capitalism* (Cornell University Press, 2006), p. 6.

plans, such as 401(k) plans in the United States, so that employees who switch employers would not sacrifice their retirement benefits.

Over the past decade, the Japanese government has made considerable progress on a package of reforms that might promote a more active labor market, but it has watered down some measures and failed to complete others. In any case, government policy by itself is not sufficient to transform corporate practices. For a true labor market to emerge, companies would have to renegotiate their compacts with their workers and redesign their systems of employee representation. They would have to become less loyal to their workers, and the workers would have to become less loyal to them. And there would need to be sufficient numbers of employers looking for workers and workers looking for new employers to provide ample liquidity in the market.

Likewise, to cultivate a real capital market, the government would have to enact substantial reforms in financial regulation and corporate governance, as well as in areas less directly related to capital markets, such as pensions, antitrust, and taxation. Here again, the Japanese government has made substantial progress on this agenda, but it has not completed the full slate of reforms that would be required. To create a market for corporate control, it would have to abandon its propensity to protect domestic financial institutions and corporations and to manipulate financial markets. Corporations would have to go even further in unwinding cross-shareholdings, become less loyal to members of their corporate group, and embrace a philosophy of maximizing shareholder value. Shareholders would have to become more assertive in pressing managers to maximize returns. And banks would have to stop protecting their main bank clients from takeover bids.

Deregulation and Variations across Sectors

I now turn from market reform in the broadest sense, the enhancement of the basic market infrastructure of an economy as a whole, to market reform in a narrower sense, as it is more commonly studied in advanced industrial countries—that is, regulatory reform designed to promote competition in specific sectors. Both of these types of reform require "more rules," but they do so in a slightly different sense. In the first case the government and the private sector enhance the basic institutions that govern markets, whereas in the second the government intervenes more actively to create or to sustain competition in sectoral markets in which private actors are prone to collude or competition is not likely to emerge on its own. Here the analyst needs to pay greater attention to cross-sectoral variation.

Given the argument presented thus far, one must be wary of making a simple dichotomy between "regulated" and "unregulated" sectors. All sectors are governed in the sense that they rely on a common market infrastructure; all sectors are subject to social regulations such as health, safety, and environmental codes; and all sectors are subject to economic regulations in that "unregulated" sectors are inevitably linked to "regulated" sectors. In fact, some of the most heavily regulated sectors—such as finance, energy, transport, telecommunications, and retail—constitute the core infrastructure for the rest of the economy. These caveats aside, there is a qualitative difference between sectors that are subject to direct economic (price and entry) regulation, such as the infrastructure sectors just listed, and those that are not, such as most manufacturing sectors.

The deregulation movement that began in the United States in the mid-1970s and spread to all advanced industrial countries (first to Britain and Japan and then Western Europe) sought to curtail both economic and social regulation, but with the emphasis on the former.[12] A driving force behind the movement in the United States was an unusual bipartisan coalition that included academics and business and consumer groups. Economists challenged the public interest rationale for regulation, arguing that policymakers should not assume that any market failure requires government regulation as a response but should carefully weigh the costs and the benefits of regulation. Furthermore, they contended that technological change and market dynamics had undermined the original rationale for regulation in many sectors.

Yet as noted earlier, the movement achieved little true deregulation, but rather a combination of liberalization with re-regulation. Of course, liberalization does not *always* beget more rules, as Peter Schuck points out in chapter 16 of this volume. I would add, however, that it usually does. The U.S. government came closest to true deregulation (freer markets and *fewer* rules) in the airline industry, where it eliminated an entire regulatory agency (the Civil Aeronautics Board) and abandoned economic regulation. Even in this case, it coupled deregulation with a substantial strengthening of safety regulation.[13] By contrast, other deregulation programs have been accompanied by an explosive proliferation of rules. Britain's Thatcher reforms of the 1980s, for example, led to the creation of no less than twelve new regulatory agencies. Most notably, its "Big Bang" financial liberalization of 1986 coincided with the passage of the Financial Services Act, which ushered in a far more extensive, intrusive, and legalistic regulatory regime. In the one country with hard data on the actual numbers of regulations—Japan—an explicit goal of regulatory reform was to reduce their number. In utter frustration, officials saw the number increase instead. For every regulation they eliminated, another would somehow emerge.[14]

The logic by which liberalization drives re-regulation varies according to the nature of the preexisting regime and the character of the transition toward greater competition. A shift from monopoly to competition typically requires pro-competitive regulation to jump-start competition (see the discussion of telecommunications in the following paragraphs). A transition from public to private provision of services often requires new regulation to mandate public service requirements (such as universal access or interoperability) that were previously met directly by the public corporation. An increase in the number and diversity of market players generally demands a more codified regulatory regime ("more rules" in the literal sense). And an intensification of competition may spur companies to behave worse (to produce greater externalities), therefore requiring more social, environmental, or other types of protective regulation.

When British authorities launched a bold telecommunications reform program in the early 1980s, advocates recognized that they would need to increase regulation in order to generate competition, but they believed that this would be a temporary phenomenon: as competition took hold, they expected regulation to wither away.[15] To the contrary, regulation of telecommunications has turned out to be an ongoing necessity to sustain and govern competition. In every case of telecommunications reform, the government initially had to confront the monopoly power of the incumbent service provider. The incumbents held an overwhelming advantage because they owned and operated the national infrastructure, possessed access to all existing customers, dictated technical standards, and commanded the relevant technical knowledge and expertise in the sector. So the government could not simply allow competition—it had to *create* it. It usually did this with some form of "asymmetric" regulation: imposing restraints on the incumbent and giving advantages to the competitors. It could break up the incumbent into multiple companies (divided along functional or regional lines, or both), force the incumbent to reduce charges in noncompetitive areas (such as local service), prohibit the incumbent from lowering charges in competitive areas (such as long distance), restrain the incumbent from introducing new services, and require the incumbent to lease its lines at reduced rates. This last measure was critical, because the incumbent carrier controlled the phone lines, so creating competition meant forcing the incumbent to lease lines to its competitors. The regulatory battle then hinged on the rate of the interconnection charge the incumbent would levy on its competitors. In many

cases, the incumbent and the competitors devised complex rationales to justify their own position (incumbents favor "historic" cost calculations whereas challengers prefer "incremental" costs), yet these debates essentially concerned political judgments about how far to favor the incumbent versus the challengers. This is a never-ending process because the incumbent never completely loses its structural advantage, and technological and market changes require constant recalibration of the regulatory balance.

Given the growing complexity of the telecommunications sector and the interrelationships between its many lines of business (land-based telephony, mobile communications, satellite communications, cable television, Internet services, and so on), the overall level of regulation is more likely to increase than to decrease. Mobile technology has altered the dynamics by allowing new carriers to challenge incumbents without relying as heavily on the incumbents' land-based network. Yet to the extent that mobile customers call other customers on the incumbent's land-based network, the mobile carriers still face the issue of interconnection charges. Ongoing market developments are bound to change this further, but regulators are not likely to reach a point in the foreseeable future where they can simply withdraw and let free and fair competition take over (see chapter 11).

Other network industries share some common features with telecommunications. For one thing, they are natural monopolies since the network infrastructure is so costly that duplication would be inefficient. Hence liberalization takes the form of fabricating competition over a common infrastructure. Governments strive to achieve this in a variety of ways. They can opt for franchising, whereby they grant monopoly franchises to operators for a limited period via competitive bidding. They can adopt a highway model in which the government runs the infrastructure and allows operators (such as trucking companies) to compete freely using that infrastructure, but this is more difficult in other sectors (railways, telecommunications, energy). The British government tried this approach for railways, creating a single public rail track authority and auctioning franchises to service providers, with problematic results.[16] In energy sectors, governments have generally separated generation from distribution, allowing competition in generation while restricting it for distribution. They have also distinguished between large corporate users and household consumers, allowing more competition in the industrial sector (see chapters 6 and 7).

In many cases, decreases in economic regulation are accompanied by increases in social regulation. Regulators typically fear that companies faced with greater competition will be more likely to compromise health, safety, or environmental standards. Trucking companies might push their drivers to work too hard, airlines might take shortcuts on safety codes, or utility companies might lower standards for pollution emissions. To compensate, governments strengthen regulations in these areas. Many of the old licensing regimes fused economic and social regulations: the same licensing system served to limit entry and to maintain standards of conduct. So the task of regulatory reform is to separate economic regulation from social regulation and to reduce the former while increasing the latter.

In finance, the connection between liberalization and re-regulation is particularly striking. In chapter 3, Jonathan Macey describes this logic persuasively in relation to the banking sector, so I shall not present the case here. The need for perpetual regulation is equally compelling on the securities side, but the rationale is different. In order for capital markets to operate properly, investors must have accurate information about the financial circumstances of publicly listed firms. Insiders must be prohibited from taking advantage of information available to them at times but not to the broader public, and managers and large investors must be prohibited from manipulating share prices for short-term gain. Moreover, corporate boards must be required to serve the interests of the shareholders as a whole. In recent years, governments have responded to various scandals by substantially strengthening regulations on securities transactions and corporate governance (see chapter 4).

Across subsectors and countries more broadly, the general trend has been toward not only greater competition but also massive expansion of financial regulation. Governments have eliminated many forms of price regulation, such as regulations on deposit interest rates and stock commissions, and lowered barriers between business lines within finance (banking versus securities, for example). At the same time, they have substantially augmented and codified other types of regulation, such as prudential supervision and disclosure requirements. There is a logical connection between these two facets of reform, because intensified competition begets greater incentives for risky behavior, which requires tougher regulation, and brings in new players who are less likely to play by informal rules, which spurs further codification.

Ultimately, as noted at the outset, scholars need to develop language to move beyond the presumption of a negative relationship between regulation and competition by recognizing the government's various roles in the market. In an earlier work, I proposed four categories of regulatory reform that strive to create more competition yet entail more regulation, not less.[17] *Pro-competitive re-regulation* offers regulatory advantages to competitors or imposes disadvantages on incumbents in a market where competition is not likely to arise naturally, such as basic telephone service. *Juridical re-regulation* adds more detail to existing regulations, by putting tacit rules into written form or by putting administrative rules into legal form. *Strategic re-regulation* favors particular firms, often national champions, within a newly opened market. And *expansionary re-regulation* creates new regulations to prevent the loss of bureaucratic authority that can accompany the liberalization process, or to simply take advantage of the process to expand administrative powers.

Alternatively, one might devise analytical categories specifying the varieties of market reform rather than the (related) varieties of re-regulation. For example, market reform might be divided into two broad categories—primary and corollary measures—and each of these subdivided further. Primary measures would include (1) enhancing the basic infrastructure of a market economy, such as the financial and legal systems; (2) strengthening related policies that sustain competition, such as disclosure requirements and corporate governance codes; (3) tightening antitrust policy and pro-competitive regulation; (4) removing or relaxing anticompetitive regulations; and (5) reducing the government's role in functions that could be performed by private actors. Corollary measures would include policies that tend to accompany the market reform process and facilitate it for functional or political reasons. For example, governments typically couple reductions in economic regulation with increases in health, safety, and environmental regulations for the functional reasons outlined earlier. They also couple liberalization with politically motivated adjustments, such as compensating social groups for the costs of increased competition via subsidies, insurance, or welfare policies.

The Market Reform Process

Thus far I have argued that a sophisticated understanding of the relationship between regulation and competition, and between governments and markets, is a prerequisite for understanding the market reform process in advanced industrial countries, which is the primary concern of this volume. While I have introduced various examples to illustrate this point, let me conclude by recapitulating the argument, with special attention to its implications for the market reform *process*.

1. *Market reform is a highly complex process precisely because it entails building new institutions and not simply removing barriers.* The standard government-versus-markets rhetoric is misleading particularly because it implies market reform should be easy: just get the government out of the way and markets will flourish. In this view, the only reason things do not work out

this way is political opposition: vested interests that benefit from protection and regulation block liberalization. But this argument misses a critical part of the story: it is actually not easy to enhance market systems or to make them more competitive. In other words, the challenge of market reform is functional as well as political, and the political difficulty is compounded by the functional complexity. As stressed throughout this volume, this implies that market reform requires considerable attention to the specifics of *market design.*

2. *Market reform often requires not just one policy change but a wide range of interrelated measures.* This reflects policy linkages, or "macro-macro" links. As Japanese labor and capital markets demonstrate, reform in one area might only have its intended effect if combined with related measures in other areas. Linkages across policy areas may be political as well as functional. For example, many argue that Japan cannot fully liberalize service sectors because it lacks a sufficient social safety net in the form of a well-developed unemployment insurance system. That is, policymakers recognize that more competition would mean greater labor dislocation and unemployment, and they judge that this would be politically unacceptable because they do not have sufficient policies in place to cope with such dislocation.[18] I would put this slightly differently: in the Japanese context anticompetitive regulation *is* a critical component of the social safety net. Once this connection becomes clear, the Japanese government's response to its long-standing economic malaise makes more sense. The government has been slow to liberalize service sectors in order to avert labor dislocation, and it has been slow to develop a more standard social safety net in order to avoid greater liberalization of service sectors.[19]

These policy linkages also shed light on the failings of partial reform. Many reforms do not achieve the expected results because they have enacted one part of a policy package but not another. Or even worse, they have generated or exacerbated major crises via incompatible combinations of policies or poor sequencing. In the case of the U.S. Savings and Loan (S&L) crisis, which some blame on financial liberalization and others on too little liberalization, it would be more accurate to blame the particular combination of policies in place at the time. The government had deregulated deposit interest rates, liberalized the S&Ls' use of funds, and maintained deposit insurance—giving the S&Ls both the freedom and the incentive to take greater risks. But it did not increase prudential regulation (see chapter 3).[20] A decade later, Japan triggered a full-fledged banking crisis by combining poor macroeconomic management, financial liberalization, and a tacit guarantee to bail

out failing banks with lax banking supervision.[21] Likewise, poor policy coordination played a major part in the California energy crisis of 2000–01 (see chapter 7).

3. *Market reform is not simply a process of policy change, but a combination of policy change and societal response.* This reflects public-private linkages, or "macro-micro" links. Any account that focuses on only the public side risks missing the essence of what is happening. Market reform often means replacing existing market institutions with alternatives. This includes not only switching from one type of government regulation to another but also switching modes of governance, replacing government regulation with private sector regulation and vice versa. Market reform often requires a broader transformation of social norms as well.

This interaction can take many forms. In Japan, government policies to liberalize markets have often been accompanied by private sector efforts to insulate businesses from the full force of competition.[22] When the government removed capital controls in the 1960s, corporations responded by substantially increasing their cross-shareholdings to protect themselves from foreign takeovers. When the government moved forward with trade liberalization in the 1970s, some industries replaced tariffs and quotas with private sector substitutes, including preferential procurement practices, exclusive dealerships, and cartels. Kodak argued this point in its case against Fuji Film before the World Trade Organization, contending that Japan's Ministry of International Trade and Industry worked with Fuji to establish exclusive dealer networks that effectively shut out foreign suppliers. And when the government implemented sector-specific liberalization (deregulation) in the 1980s, the removal of government regulation sometimes failed to spur competition or was replaced with outright collusion among producers. The liberalization of deposit interest rates, for example, led to very little actual competition for deposits based on price.[23] More recently, Prime Minister Junichiro Koizumi pledged to double foreign investment into Japan by 2008, particularly through measures to facilitate foreign mergers with and acquisitions of Japanese companies. At the same time, the government enacted corporate law reforms for corporate takeover defenses and issued guidelines to clarify what defense strategies would be legal and appropriate. In response, companies rushed to prepare defenses to insulate themselves from foreign takeovers.

For a different example of public-private linkages, I turn to labor market trends in the United States, Germany, and Japan. I cannot capture the full complexity of this story here, but a stylized interpretation should illustrate the general point that government reforms and private sector developments do not necessarily coincide. I would characterize the broad trends as liberalization without policy change in the United States, policy change without liberalization in Japan, and partial liberalization via policy change in Germany.[24] Over the past two decades, the U.S. government has made no major changes to labor law, but adjustments in policy implementation and corporate practices have combined to produce more competitive labor markets. The Japanese government has enacted considerable policy reforms, as already discussed, yet corporate practices have not been greatly transformed. After years of stalling, Germany moved forward with substantial reforms beginning in 2003, which had more impact than in Japan because the legal framework plays a greater role in structuring labor markets.

4. *There is no single equilibrium for optimal market reform.* Perfect markets do not exist, but they can serve as a useful fiction for analytical purposes. Many experts also assume that they provide an optimal target against which to assess reform progress. But the positive relationship between regulation and competition complicates this exercise. Market reform advocates themselves are divided over the merits of the laissez-faire variant of liberalism as opposed to a more pro-competitive approach. The former are more skeptical of the benefit of government action to generate or enforce competition, while the latter are more favorable toward aggressive antitrust policy and pro-competitive regulation. This philosophical difference is at the heart of many policy debates, such as those surrounding the Microsoft antitrust case or rulings by the Federal Communications Commission.

5. *Market reform is inherently a political process.* This final point may be the most obvious one of all, but points 1–4 help to explain *how* and *why* this is so. It is not simply that government regulation generates winners and losers, and therefore regulatory decisions involve political battles. Market reform is inherently so complex, with linkages across policy arenas and combinations of government policy and private sector response, that the process is bound to be more political than it would be if it were just a matter of repealing a specific regulation. Moreover, because there is no agreed-upon target for market reform, even among its advocates, the political process inevitably involves a contest of ideas as well as a clash of interests.

Notes

1. On the historical evolution of markets, see Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 1944); and Douglass C. North, *Structure and Change in Economic History* (New York: W. W. Norton, 1981). On post-communist transition, see Stephen Cohen and Andrew Schwartz,

"Deeper into the Tunnel," in *The Tunnel at the End of the Light: Privatization, Business Networks, and Economic Transformation in Russia,* edited by Stephen Cohen, Andrew Schwartz, and John Zysman (University of California, Berkeley, 1998), pp. 1–23; and Joseph Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton, 2002). On development, see Kiren Chaudhry, "The Myths of the Market and the Common History of Late Developers," *Politics and Society* 21 (September, 1993): 245–74; and World Bank, *World Development Report 2002: Building Institutions for Markets* (Oxford University Press, 2002).

2. Adam Smith, *The Wealth of Nations* (University of Chicago Press, 1976), especially bk. 5; Milton Friedman, *Capitalism and Freedom* (University of Chicago Press, 1962), pp. 22–36.

3. Ronald Coase, "The Nature of the Firm," *Economica* 4 (November, 1937): 386–405; North, *Structure and Change in Economic History;* Oliver Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985).

4. Polanyi, *The Great Transformation;* Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology* 91 (November, 1985): 481–510; Neil Fligstein, *The Architecture of Markets: An Economic Sociology of Twenty-First Century Capitalist Societies* (Princeton University Press, 2001).

5. Peter Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford University Press, 2001).

6. Colin Crouch and Wolfgang Streeck, eds., *Political Economy of Modern Capitalism.* (London: Sage, 1997).

7. Smith, *The Wealth of Nations.*

8. Charles E. Lindblom, *Politics and Markets: The World's Political-Economic Systems* (New York: Basic Books, 1977), pp. 107–14.

9. This section builds on Steven K. Vogel, *Japan Remodeled: How Government and Industry Are Reforming Japanese Capitalism* (Cornell University Press, 2006).

10. Japan's "lifetime" employment system for core employees at large companies is complemented by more flexible employment relations for noncore employees. "Permanent" employees, mostly men, enjoy higher status, salary, benefits, and job security than "temporary" workers, mostly women.

11. On this point, the United States is more the outlier than Japan. While some European countries have more active mergers and acquisition markets than Japan, none have a market for corporate control comparable to that of the United States. For that matter, the United States only developed an active market for corporate control in the 1980s. See chapter 4 in this volume.

12. This section builds on Steven K. Vogel, *Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries* (Cornell University Press, 1996).

13. Martin A. Levin, *Making Government Work: How Entrepreneurial Executives Turn Bright Ideas into Real Results* (San Francisco: Jossey-Bass, 1994), pp. 45–47.

14. The number of regulations increased from 10,054 in 1985 to 12,376 in 2005. (Ministry of Internal Affairs and Communications data).

15. Stephen Littlechild, *Regulation of British Telecommunications Profitability* (London: Department of Industry, 1983).

16. Vogel, *Freer Markets, More Rules,* pp. 124–25.

17. Ibid., p. 17.

18. Jonah Levy, Mari Miura, and Gene Park, "Exiting *étatisme*? New Directions in State Policy in France and Japan," in *The State after Statism: New State Activities in the Age of Liberalization,* edited by Jonah Levy (Harvard University Press, 2006).

19. In other words, the government does not have an easy way to move from one political equilibrium (employment maintenance, or anticompetitive regulation as social protection) to another (employment adjustment, or more competition coupled with unemployment insurance as social protection).

20. Levin, *Making Government Work,* pp. 42–43.

21. Ryoichi Mikitani and Adam S. Posen, eds., *Japan's Financial Crisis and Its Parallels to U.S. Experience* (Washington: Institute for International Economics, 2000).

22. On the trend toward private sector governance in Japan since the 1980s, see Ulrike Schaede, *Cooperative Capitalism: Self-Regulation, Trade Associations, and the Antimonopoly Law in Japan* (Oxford University Press, 2000).

23. Vietor argues that U.S. incumbents responded to deregulation not by outright collusion but by devising market strategies to impede new entry, including market segmentation and manipulation of distribution channels. Richard H. K. Vietor, *Contrived Competition: Regulation and Deregulation in America* (Cambridge, Mass.: Belknap Press, 1994), pp. 320–21.

24. In chapter 5, Hacker elegantly describes how U.S. policy drift has led to substantial changes in the pension regime in the absence of major policy change.

3

Regulation in Banking: A Mechanism for Forcing Market Solutions

JONATHAN R. MACEY

State regulatory autonomy masquerading as "deregulation" sometimes distorts the operation of markets in ways that threaten to create crises with national consequences. Examples of banking regulation and deregulation indicate that regulation, contrary to common opinion, can actually foster markets, while deregulation tends to be successful only when coupled with a strong guiding hand from government.

In the case of the United States, banking regulation often is suboptimal because states are subject to a variety of moral hazard problems that weaken their incentives to regulate effectively. In particular, when states regulate banks, they have incentives to create rules that promote excessive risk taking, because the states disproportionately benefit when banks are successful but share losses with other states through the U.S. system of national deposit insurance when banks fail.

Banking: Economic and Political Theory

Three core structural features distinguish banks from other sorts of business in the economy.[1] First, banks are much more highly leveraged. Well-capitalized banks have debt-equity ratios around 10:1, as opposed to the 1:1 debt ratios typical of nonfinancial firms.