

REFGOV

Reflexive Governance in the Public Interest

Institutional Frames for Markets

RefGov-IFM Policy Briefs:

The legal, political and economic dynamics of market regulations

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The starting point of the IFM contribution to the RefGov project is that that worldwide, markets, and more precisely rights based management systems tend to replace command and control centralized regulation, which generally has not been successful in managing the provision of many so called “public goods” as well as natural resources. Rights based management generally involves setting a cap on total output, the assignment of shares of the cap as property rights, and their subsequent trade. These arrangements demonstrated effectiveness in mitigating the losses of open access; providing incentives for efficient resource use and investment; generating information regarding alternative options; and creating a mechanism to directing resources to their highest valued uses. The rationale behind that is that markets could yield wealth because they favor the revelation of shadow prices that exist in non-market mechanisms and favor all kind of inefficiencies and capture or rents.

Creating markets to favor a better use of resource raise however two essential issues: what mechanisms will guarantee a better alignment of incentives and revelation of information? And how the benefits should be distributed? Hence the investigations carried out in the IFM sub-network about the institutional embeddedness of markets and the constraints facing the building and management of efficient markets.

While citizens-consumers are most of the time those who ultimately pay for the harm and benefit from the wealth associated to the implementation of market, alternative options in distributing property rights when building markets impact on the ability of the various stakeholders to capture, temporarily or definitively, rents that delay or reduce the benefits to be expected from the more efficient mechanism. “Efficiency” in trade and “justice” in distribution have often little chance from being aligned, and the drivers of market building are therefore very likely to be impacted by all kind of strategic games among stakeholders; hence the interest of the IFM sub-network scholars for market building processes. Many of their findings are concentrated in a forthcoming collective book dedicated to the interacting logics behind the “manufacturing” of markets through interactions between market players, political actors and institutional settings, in particular the law (Brousseau and Glachant (2011); see the table of content in the Apendix).

The political-economy of market design

The diversity and intertwining of market institutions

Developing systems of exchanges implies first to develop “measurement” systems aimed at guaranteeing the property of traded goods and the rules framing the exchange — are designed and established. The extension of markets request formal and non-manipulable measurement systems, as the variety both of commodity and of players increase. The emergence of these “objectivation” systems is however the result of processes by which economic players and private interests promote their preferred systems of measure (Velkaar, 2011). Moreover, by the end, the successful measurement standards are integrated by market players who establish their strategies and invest in assets according to the established standards, which feedback on the credibility of these norms. Compliance is linked to their acceptance by all the players, which makes them quite difficult to manipulate ex-post, even if they result from manipulation ex-ante... which underline why norms are so essential stakes and why it is relevant for market player to invest heavily in strategies to establish them and ensure their diffusion. In turn, the dynamic of market integration mechanically increases the bargaining power of the demand side since buyers face a greater number and variety of suppliers, hence their ability to force the supply side to comply with measurement standards and technologies that decrease the manipulability of trade.

Barcala, Gonzalez-Diaz, and Raynaud (2011) survey and analyze how various institutions solve or at least mitigate the assessment of quality. They disentangle and classify alternative way of manufacturing quality either through state intervention (regulation), or through private investments (e.g. brands) or thanks to collective organized actions by networks and communities (e.g. certification). The analysis of the interactions between these various solutions highlight more complementarities than substitutability, while this latter exist. All in all, the governance of quality necessarily combines a great diversity of mechanisms because the attributes to be measured are so numerous and so different that the cost minimizing solutions for each of these dimensions differ. One of the conclusion is that public institutions are better when it is question of vital risks (both for the population in general and for the transacting parties); while private solutions outperform public ones when it is a question of matching between the two parties utility functions (e.g. Consumer satisfactions vs. Firm’s profit). Aglietta and Scialom (2011) demonstrate convincely that the management of systemic risk does not only request public regulation, but also strong capabilities from the public authorities to force market operators to reinternalize the(systemic) risks that are by definition externalities.

Arruñada (2011) points out however that agents do not trade goods, but rights which are fundamentally mutual commitments among members of a society; hence the centrality in a market economy of reliable and wide scale available systems of “objectivization” of actual rights. In this context, the development of modern systems of exchange can be pictured as a competition between two different technologies and the actors operationalizing them: the artisan manufacturing of contracts by lawyers and notaries and the industrial production of “legal commodities” by default contract rules and organized registries. In this context, something close to a luddite attitude is often observable when legal professionals oppose standardization of legal acts and services, or when they claim the higher quality of personalized service. Nee and Opper (2011) on

their side demonstrate that this securization of contract and rights relies heavily on the development of skilled and neutral public bureaucracies ensuring the impersonal and systematic enforcement of rights.

These highlight the centrality of centralized exchange systems that tend to objective trade as intensively as possible. That said, any exchange system result from a tradeoff between the collective will to reduce transaction cost and the “natural monopoly” characteristics of three main and complementary activities that allow such a reduction: trade execution, clearing and settlements (Pirrong, 2011). This gives agents involved in these platforms strong ability to capture all kind of rents, especially by vertically and horizontally integrating activities and by setting pricing schemes for trading services as well as rules. The heterogeneity of these actors, bypassing technologies (as Information Technologies) and competition among exchanges prevent however full capture.

All in all, one of the main conclusions of our research program on the “manufacturing” of exchange systems is that to draw the social benefits of the superior social technology that “the market” is, strong framing and oversight of these market by public capabilities is a requirement. “Natural markets” do not perform spontaneously optimally...and we will see that they even cannot exist. They have to be built, to be “manufactured”.

Reforming and building markets

Indeed, modern markets are not only systems to perform transactions, they organize competition to favor innovation and the permanent seek for efficiency. However market competition is not at all natural and requests severe efforts to be built.

On the basis of the very long run history of civilization, Wallis (2011) clearly highlight that markets are the fruits of political compromises and that therefore it is “natural” that their (inefficient/specific) organization generate rents for the political coalitions that support the existence of the market and, eventually, for the organizations that enables the market to perform. To a certain extent, it is meaningless to consider rents generated by limited competitiveness of markets as inefficient since they remunerate in fact the political coalition that make market possible. In the same time, these rents correspond to resources that could be allocated to expand the stock of productive assets if they were not used to remunerate the political coalition, which explains the superior efficiency of open access societies, and then the call by some to organize more open, transparent and integrated markets.

This point of view is illuminating to understand the strong constraints hindering the capability to integrate markets and to promote an open and fair competition. Markets are inherently the objects of political manipulation and government(s) intervention. This explains why so few markets operate as economic textbook describe market performance, and why it is so difficult to “regulate” markets.

For instance, Manganelli, Nicita, and Rossi (2011) analyze the very complex system of formal institutions involved in the implementation of competition policies. They highlight that it involves so many branches and level of government, not mentioning self-organized mechanisms, that there are neither a clear hierarchy of norms, nor a rational design of the bureaucratic and political bodies in charge of their enforcement. The actual power is so divided among so many different entities in the EU today, that most of them cannot figure out how their behavior will impact on other’s authorities. The resulting lack of coordination is not only a question of incentives — all these entities

facing contrasted agenda —, it is also a question of complexity. Instead of calling for “rationalization” which would be both hard to figure out, and almost impossible to implement, this calls for, a more evolutionary and “biological” understanding of complex institutional systems. Institutional arrangements are full of overlapping and redundant imperfect components that all in all control each other to avoid major drifts, catastrophic evolutions and systemic collapse due to bottlenecks. In the same time, redundancies and overlapping avoid optimization and prevent costs minimization. This could be considered in such a perspective as the irreducible costs of reliability and sustainability in the long run.

One of the consequences of the complexity of the political systems framing the organization of markets (and industries) is that they are both difficult to control and to predict. The first point is well illustrated by Karagiannis and Héritier (2011) who show how the US government, while hegemonic, lost control in the building of a market; in that case the international air transportation market. The competition among government’s departments led the US to play too aggressive. This favored the unification of Europe who was able to get conditions much more favorable to European carriers than it should have been given the balance of power between the two continents. The second point. On its side, the story of the reform of the electricity industry in Great Britain, shows that the result was unexpected by all actors, including its promoters (Littlechild, 2011). During its various stages of implementation, individual plans and strategies evolved, as well as coalitions. An incremental process of discoveries and collective learning, modified the framework of the bargaining process among interest groups and various public bodies, which led to a set of reforms that was not envisioned at the early beginning. Institutional evolutions are thus highly path dependent, which explain their unpredictability and then the potential disruptive changes in the strategy of players.

This constrains severely any governmental attempt to implement reforms aimed at implementing more efficient markets. This is not only the consequence of defaults in the political process — like the potential too high sensibility to interest groups —, but also the result of the fact that institutions have to be adhered to by individual agents; both citizens and firms. The shaping of inter-individual contracts reflect their strategy, depending of the context, in trying to manipulate economic assets either to protect their wealth or to benefit of transfers of value. Their aggregated (while uncoordinated) forces are well beyond the one of any government, which produces permanent risk of catastrophic evolution. In the same time, the only tool to channel these forces to avoid the collapse of a given system and to make of stability a focal point and mutually shared belief, is to have the government mixing threats and incentives to push convergence of beliefs on the un-profitability of diverging strategies, hence their ineffectiveness. The role of the ruler as the builder of converging expectations and beliefs appears then as essential; hence the centrality of credibility of authorities.

In that perspective, several historical examples (see Sgard, 2011; Neal, 2011) highlight the obstacles facing those who attempt to build markets by rational design. Typically more decentralized, progressive and “biological” management of reforms and crises favor the resilience and the adaptation of the arrangements among economic players, while rational and central design tends to prevent solid micro-foundations for economic activities. Indeed, authoritarian writing-off of rights and commitments (as debts) and tight regulation hinder investments, while public intervention taking for granted

existing rights, even if they can be flexibly renegotiated and amended, does not deprive investment and innovation.

That said, fine tuning in the manufacturing of market is difficult to perform. The logic of political decision-making indeed leads the temporary dominant coalition to capture much of the benefits of any reform, generating a significant group of losers whose interests can be ignored by the policy decision makers or other interest groups in the short run (Henisz and Zelner, 2011). This translates into patches to the reforms that are implemented in an inconsistent way, leading to inefficiencies triggering a following “radical” reform generating the same cycle. Other studies point out how the lack of credibility of public authorities leads to implement apparent but ineffective governance solutions (Chong, Staropoly and Yvrande-Billon, 2011). Hence, clearly political constraints prevent “rational” public decision makers to govern in function of the public interest, even if they would like to be “benevolent dictators”.

The central role of regulators

In that context, regulators, these bodies responsible for the implementation and development of market regulations, can be seen as essential devices in the governance of modern markets, especially in the context of regional and global integration.

Regulators are constrained by their relatively weak position in the multilevel and multichannel system of governance. On the other hand, their decision-making logic and their fuzzy status allow them to become both shock absorbers and coordinators of institutional evolutions. This implies, however, an ability to implement new tools, especially in an international context.

The need for Benevolent Public Rulers

Regulators have two typical characteristics being relevant for the ordering of regulated markets and industries. First they are “civil servant” (or service) away from political competition: they are less sensitive to special interests, and have at least to take several conflicting interests into consideration to establish and maintain their legitimacy in the long run. They are also “Public Delegation” holders, and retain an asymmetric administrative power vis-à-vis the regulated industry and other agents. This zone can be larger or smaller but it always exists if regulators are regulating authorities. Hence, the need to better take into account the behavioral economics of regulators, and to open the “regulatory authority black box” to understand how they could contribute to a better governance of markets and market reforms.

Behavioral economics of regulators

Usually regulators are there to manage conflicting claims between those of the users/consumers and those of the industry (otherwise we would need only antitrust authorities), taking into consideration the specificity of the socio-economic constraints of the considered activity. In addition, the fact that they are “independent administrative authorities” provides them with a status that immune them from direct pressures from the market players, and protect partly from political pressure. Their institutional weakness — because their status is rarely “constitutionalized” and because they are submitted to oversight by the legislative, the judiciary and the government — can also be considered as a potential source of strength because it provides them with incentives

to build a strong legitimacy, especially by becoming neutral arbitrators among particular interests. All in all, regulators often develop legitimacy in becoming neutral builders of the common/general interest.

Moreover regulators hold public delegations, which empower them. While they are neither “law makers”, nor gifted with the high endowment benefitting to many market players, they have the ability as conflicts settling entities and “agenda setters” in the implementation process of regulations to influence the actual rules framing the activity in a given industry.

In particular their delegation to manage the implementation of a regulation provides them both with an actual degree of authority, and with an ability to become a “truth revelation platform” because stakeholders have interest in providing them with relevant knowledge and information. While stakeholders provide information to influence the ruler in their favor, they might be deterred to lie because this would weaken their credibility toward the ruler that, as central body, can cross information provided by alternative stakeholders (in a context where competing interest have strong incentives to raise objections and hinder each others’ reputation).

It should be pointed out, in addition, that in a context of high uncertainty — which is the case in any process of institutional transformation — the various interests in a given industry might have strong incentives to benefit from a truth revelation mechanism, because it facilitate convergence of anticipations, and therefore stabilize strategies and secure investments. This reinforces the regulators ability to become a credible “truth revelation platform” for a given industry; leading to a greater ability, then legitimacy, to rule adequately.

Biased preferences of “independent” but national regulators

Regulators are however inherently biased. Since their legitimacy relies largely on their ability to avoid major disruption in the provision of service and major systemic crises, they tend to act as risk minimizing agents. As a consequence it is very likely that regulators are more sensitive to lobbies proposing solutions to “stabilize” the industry trajectory or smooth path of changes, to the detriment of pro- efficiency reforms.

Also, emanating from national regulatory frameworks, regulators tend to favor local or national welfare as opposed to regional or global one. Being accountable (at best) only for their domestic markets, regulators have no incentives (beyond means) to take into account any beyond-border effects, especially by coordinating internationally with other national regulators.

Potential remedies

In the same time, since regulators need to improve their competence in ruling their industry and settling conflicts among the various stakeholders, they might well have the rights incentives to develop tools aimed at boosting their capabilities. In that perspective two set of tools seem essential.

Open fora

First of all, it is in the interest of regulators to boost the informational competition among those who try to influence them. They can do so typically in making public the exchange of information they have with the various stakeholders, so that to enable any

information conveyed to the regulator to be challenged; which is highly truthful compatible. One of the additional tools they could use is the power of digital technologies. Making information public on a very large scale through digital network is clearly a mechanism favoring an information competition at a large scale and therefore a strong “objectivation” of market rules and competitive behaviors. In a dynamic perspective, digital networks can clearly serve as “anti-Microsoft” innovation tool by maintaining open access to knowledge, and “anti-GoldmanSachs” crises prevention tool, by improving the ability to assess the level of risk in a system and, at least, to better manage the early phases of systemic crises by providing just-in-time information sharing capabilities to the players.

Coordination among national information fora

In the EU or at a larger scale, international fora of regulators could greatly enhance both their national ability to rule, and the consistency among existing regulatory frameworks. Regulators are incited to share information across national borders, both because they can learn from other practices, and because many firms operate on various national markets. Not only this can have strong impacts in terms of quality of national regulations and consistency among them; but also a soft coordination among regulators is a very practicable way of overcoming the so-called European “regulatory gap”. Regulators can partly bypass the complexity and the difficulty of political bargaining associated to processes of law enactment at the EU or at the international level, because they mainly make decisions (not pass laws) and may have a strong “technical” legitimacy to do so.

Appendix1: Most Significant Publications of the IFM Sub-Network

- Arruñada, Benito, Foundations of Impersonal Exchange: The Theory and Policy of Contractual Registries (under contract), University of Chicago Press, Chicago.
- Brousseau, Eric and Glachant, Jean-Michel (2010) « Reflexive' Market Regulation: Cognitive cooperation in competitive information fora », in Reflexive Governance: Redefining the Public Interest in a Pluralistic World, edited by Olivier de Schutter and Jacques Lenoble , Oxford, Hart publishing.
- Brousseau, Eric and Glachant, Jean-Michel (2011) « Regulating Networks in the “New Economy”:² Organizing Coopetition to Share Information and Knowledge », in Governance, Regulations, Powers on the Internet, edited by Eric Brousseau , Meryem Marzouki and Cécile Méadel , Cambridge University Press (forthcoming).
- Brousseau, Eric and Glachant, Jean-Michel (eds) (2011), Manufacturing Markets: legal, political and economic dynamics, Cambridge University Press (forthcoming).
- Brousseau, Eric and Greif, Avner (eds) 2010. « Dynamics of Institutions and Development », Journal of Comparative Economics (special issue) (September).
- Brousseau, Eric, Dedeurwaerdere, Tom and Siebenhüner, Bernd (eds) 2011. « Reflexive Governance for Global Public Goods », MIT Press, Politics, Science, and the Environment (forthcoming).
- Brousseau, Eric, Garrouste, Pierre and Raynaud, Emmanuel (eds) 2011. « The Dynamics of Institutions in Perspective », Journal of Economic Behavior and Organization (special issue) (forthcoming).
- Brousseau, Eric, Marzouki, Meryem and Méadel, Cécile (eds) 2011 « Governance, Regulations, Powers on the Internet », Cambridge University Press (forthcoming).

Appendix: Table of Content of the Synthesis Publication of the IFM Sub-Network

Manufacturing Markets: legal, political and economic dynamics

Editors:

Eric Brousseau (EconomiX, U Paris X) & Jean-Michel Glachant (ADIS-GRJM, U. Paris XI)

Forthcoming at Cambridge University Press

Eric Brousseau, Jean-Michel Glachant, Manufacturing Markets: but what does it mean? and why it matters.

Aashish Velkar, Measurement Systems as Market Foundations Perspectives from historical markets

Marta Fernandez Barcala, Manuel Gonzalez-Diaz and Emmanuel Raynaud, How to Manufacture Quality: The Diversity of Institutional Solutions and how they Interact in Agrifood Markets

Benito Arruñada, The law of impersonal transactions

Terry L. Anderson, Ragnar Arnason, Gary D. Libecap, Manufacturing Markets”: The Efficiency Advantages of Grandfathering Allocations over Auctions

Denny Ellerman, The creation of a market for retail electricity supply

Eshien Chong, Carine Staropoli and Anne Yvrande-Billon, Auction versus Negotiation in Public Procurement: Looking for Empirical Evidence

John Joseph Wallis, Why Competitive Markets Aren’t Self-Actuating: The Political Economy of Limited Access

Stephen Littlechild, The creation of a market for retail electricity supply

Antonio Manganelli, Antonio Nicita, and Maria Alessandra Rossi, The institutional design of European competition policy

Yannis Karagiannis and Adrienne Héritier, Politics and the manufacturing of a transatlantic market for civil aviation (1944-2007)

Witold J. Henisz, Bennet A. Zelner, The Cycling of Power Between Private and Public Sectors: Electricity Generation in Argentina, Brazil, and Chile

Victor Nee and Sonja Opper, Governing Financial Markets

Jérôme Sgard, Money Reconstructed: Argentina and Brazil after Hyperinflation

Larry Neal, The Microstructure of the First Emerging Markets in Europe in the 18th Century

Craig Pirrong, Exchanges: The Quintessential Manufactured Markets

Michel Aglietta and Laurence Scialom, For a renewal of financial regulation