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A Time to Rethink Regulation
À propos de *New Perspectives on Regulation* de David A. Moss & John A. Cisternino

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Introduction

Regulation is a hot-topic, rightfully so as society is increasingly moulded by regulatory processes, from rules governing market economies, protection of the environment to even chemical and drugs available for purchase. The subject has predominated academic debate, proliferated institutional and practitioner agendas and has become a rising concern for society. The book, *New Perspectives on Regulation* (2009) proves that regulation is multifaceted and a transforming dynamic that requires a new understanding of what it means to regulate, consideration of market and social changes and inquiry about the role of the government. It is not by mere chance the appearance of such a book, in the aftermath of the financial crisis of 2008, it was revealed that the financial market is very much linked to the real economy and failures can have grave impacts for society calling for examination of regulatory policies. Although we've come far from the genesis of the market and the industrialisation era, the re-known work of Karl Polanyi (1944) reappears as it seems the embeddedness of social and market interaction is very real. The political economy moves from the rationale of regulation based on economic principles such as Adam Smith's model and rational agent paradigms to one that includes social and behavioural notions as a complex and interactive dynamic. Regulation has the challenge to swiftly revamp to the super speed of changing markets and even more to reconcile economic principles with social goals.

This book serves as a novel stimulus in the attempt to move regulation forward from out-dated ideas as well as to investigate the financial crisis. The crisis revealed something unimaginable, it was the first time systemic risk realised itself in the real world, and the spillover effects and shockwaves globally launched a series of doubt and dispute about regulation, its oversight and enforcement. The book is a product of the Tobin Project, a platform that aims to bring scholars together through out social sciences to assemble an interdisciplinary approach for dealing with real world issues. In light of the impact the crisis has had and continues until this day six years later, the book makes a fine contribution to analyse what occurred, investigate regulatory failure and propose what may be done in the future.

As a compilation of seven chapters by authors in various fields, each part provides an analysis from a different perspective. The lenses range from the market failure approach, behavioural economics, to ideas of cooperation and co-regulation, and is written with intent to speak to policy-makers as well as the general public. The following paper describes the perspectives and highlights some key points of each chapter. The overarching queries remain to re-examine the role of government in regulation, reconsider regulatory rationales and instruments for policy outcomes, and if regulation can deter such crises from reoccurring.

The Limits of the Classical Approach

The classical approach to regulation is centred on correcting market failures, especially to justify the role of government for intervening in the market. Historically this rationale has certainly moved regulation forward for dealing with issues of monopolies, information asymmetries, and the externalities of industrial production processes. It is not a surprise that a book dealing with perspectives on regulation starts with examining the classical approach to regulation and it's short fallings in the modern economy. Joseph Stiglitz in *Regulation and Failure* challenges the market failure rationale to address the problem of equity and efficiency of markets and the issue of systemic risks, as unveiled in the wake of the financial crisis. By emphasising reoccurring problems in the market, such as issues of information asymmetry and incentive structures, Stiglitz points to inadequacies of regulation based on market mechanisms to deal with the exploitation of such dynamics and the failure to meet social goals.

Regulation is conceived as both a preventative and constructive tool for modifying behaviour of market participants and consumers alike. The economic rationale to consider the market efficient without the burdens of regulation and agents as rationale (Adam Smith's model) proved to be unsustainable. This requires to further analyse the underlying incentive structures that challenge such an out-dated model. The financial crisis exposed lack of protection for the poor from bad lending practices as consumers were allured to bad mortgage loans. Even more a backwards corporate governance framework encouraged banks to engage in short-sited risky behaviour putting the entire financial system at risk. Stiglitz illustrates that the crisis was both a market and government failure, "*the primary reason for the government failure was the belief that markets do not fail*" (p. 17), which further highlights awareness about the limits of market-based regulation. Of course market failure will remain a strong key driver for regulatory policies but there is a need to modify regulatory design to include other research in social sciences.

Moving from the Rational Agent Paradigm

As it has been explored the link between incentives and regulation, then it is not without emphasis that behaviour-modification is a central mechanism of regulation. This requires to re-examine incentive structures with a shift from the rational-agent paradigm to a more nuanced understanding of behaviour in the context of the modern economy. Authors Michael S. Barr, Sendhil Mullainathan, and Eldar Shafir present such a perspective in, *The Case for Behaviorally Informed Regulation* by considering information and decision-making processes of individuals, firms and market participants. One of the reoccurring examples is that of the recent mortgage crisis where loans were given to people who may not have fully understood them and/or could not afford them. This is a fine example to dispute the theory that individuals are rational agents in the market and have perfect information. In reality there may be several impediments to such a model among which: gaps of information, contextual issues, the communication and presentation of options on consumer decision-making and most certainly a problem of 'financial illiteracy' amongst the public (p. 30). Regulation might be enriched with a behavioural perspective by bringing in notions of psychology, decision-making theories and constructions of preferences and risks according to individuals. Studies in psychology and neuroscience help to better understand these kinds of notions.

Individuals interacting with the market find their choices are influenced by firms. On the other side firms also have behavioural implications in reacting to different types of regulation. This could be translated into standards, product design, and other new requirements. Therefore, the regulation of firms might take different shape according to firm characteristics and desired aims. One strategy is to manipulate the scoring system. An example of this is the use of tax incentives where the modification is, "*the payoffs a firm will receive for particular outcomes*" (p. 35). An alternative tactic might be to completely change the playing field, that is change the "*rules*" of the game. This is done by regulating quality or types of products, whereby the firm must modify behaviour to ensure compliance; in that case the rules are changed. In addition to firms and consumers, institutions have an important part in behaviour adjustments as, "*institutions will come to play a central role in shaping how people think and what they do*" (p. 32). People's lives are impacted by the institutions they engage and identify with, for example banks monitor savings and help to facilitate future planning with credit options. All actors surveyed are interacting in the sphere of the market, so the logic of markets that is economic principles cannot be extracted from regulation. Instead it evokes for some modification to incorporate behavioural studies and angles of behavioural economics.

More Cooperation, less Competition?

With the investigation of behavioural influences of various actors in the market, and their interaction with one another then it seems only natural to move forward to investigate how regulation might cultivate such an interface. *From Greenspan's Despair to Obama's Hope: The Scientific Bases of Cooperation as Principles of Regulation*, Yochai Benkler demonstrates an evolution of regulation under a cooperative process by moving away from a model of competition. Stemming from notions of group theory and solidarity this approach challenges older ideas of the economy based on self-interestedness and selfishness, notably Greenspan's model. Instead the crisis has undermined market fundamentalism as a basis for regulation and should incorporate a new realm of social participation, that gives confidence to a degree of altruism in society. It needs to be recognised that the social context and relations in social situations is important for individuals, which requires to move from competitive models, "*New evidence refines our understanding of conditions that can sustain forms of social cooperation that are not based on either market mechanisms or command and control*" (p. 81). Cooperative systems design points to social norms, developed from experimental studies in psychology and behavioural economics.

For a cooperative system to work government agencies should involve the public in the regulatory process and encourage government to redesign programs according to the social provisioning of desired public goods. The government's role in regulation aims to facilitate cooperative social dynamics in the regulatory process to avoid future crises and risks within this approach.

More Government to Manage Risk?

La porte Saint Florian

Risk is another punch word in the current academic world, and regulation is considered a way to control risk. Tom Baker and David Moss unravel the powerful tool of government to manage risk in *Government as Risk Manager*. Society inevitably relies on government for protection and safety mechanisms from various risks, including financial, health to even environmental hazards. The management of risk is often conceived of in four ways of practice: prevention, risk spreading, risk shifting and loss control.

Insurance is one of the main institutions dealing with risk, and a pivotal factor differentiating this crisis from ones in the past. With the development of government insurance schemes, people didn't run to the banks because of federal deposit insurance and unemployment insurance helped those to cope with job loss. Insurance can be both private and public, for example health is usually provided by the former, while financial soundness by the latter. It is a remarkable institution operating on risk shifting and risk spreading. The risk of loss is shifted onto the insurance company, and risk-spreading is executed by collecting a large number of premiums that allow to diversify the risk portfolio in case of indemnification triggers.

There are however various limitations of government and private insurance programs, one of which is state-based catastrophe risk pools. Florida is used as an example that has state-based hurricane risk pool, but in reality doesn't pull enough premiums in the case of major disaster. In addition there is lack of political will to impose the right premium even for people building on coastlines and high-risk areas. As Hurricane Katrina showed, private insurance cannot be left on its own to deal with the costs of major events but requires arrangements with the government. Such arrangements between the state and the private sector for financing natural catastrophes take different shapes across countries. The CAT.NAT. system in France, based on state-run reinsurance program, is a quintessential example. In the case of extreme events the CAT.NAT is activated to help insurance cope with the losses. In New Zealand, the Earthquake Commission (EQC) operates as a state-backed primary insurance program, so the EQC directly covers homeowners from losses caused by natural disasters and is government guaranteed. Natural disasters are increasingly gaining attention in the world today as they require large amounts of capital for recovery and have become systemic and trans-boundary.

Systemic risk as a characteristic of the financial crisis requires to look attentively at institutions deemed “too big to fail”. Government as a risk manager might formulate possible insurance programs for these types of institutions, first by identifying them and then regulating them. This prompts a question of managing moral hazard, as in any situation where insurance is involved. The problem arises that if such systemically important institutions are backed by insurance they might engage in risky behavior. That might be something to further consider in all the areas that government acts as risk manager and it’s several insurance programs.

Experimenting and Assessing

It is often considered that job of regulators is to foresee risks and circumvent them ex-ante through regulation. But what if counter-intuitive effects occur? Is it always possible to know the outcomes of regulations in the real world with such a complex and changing market? What about the changing behaviour of firms and other market participants as has been explored? In *Towards a Culture of Persistent Regulatory Experimentation and Evaluation* by Michael Greenstone, a culture of experimentation and evaluation as a regulatory method is proposed. The idea is to allow for continuous learning about the effects of regulatory policies through experimenting. The main critique is to shift the emphasis from ex-ante to ex-post assessments of regulation through cost-benefit analyses. In practice Greenstone proposes to create a technocratic regulatory review board that evaluates the outcome, that is to say cost-effectiveness of regulatory policies within a certain time frame. The idea is modelled on a scientific process of experimentation, such as the U.S. Federal Drug Administration (FDA) that uses causal hypotheses, control group designs, and time frames for a bound system to test drugs before they are released to the market. High quality evidence is critical for such a system to work. The idea is quite interesting and in some way it might promote progressive regulatory practices. It could allow regulators to feel more confident in exploring different regulatory options knowing that experimentation is part of their work, leaving room to re-evaluate in ex-post analyses while avoiding to be immediately reprimanded for counter-intuitive or shortcoming regulations.

Bringing Actors Together in Co-Regulation?

In *The Promise and Pitfalls of Co-Regulation: How Governments Can Draw on Private Governance for Public Purpose,* Edward J. Balleisen and Marc Eisner argue for co-regulation in the overall institutional setting that would incorporate private actors and self-regulatory organisations (SRO). This is to understand the dangers of relying solely on self-regulatory strategies drawn from examples in finance and the environment. For example, self-regulation is critiqued for being the cause of the collapse of three large investment banks in America in 2008. These banks were delegated authority to assess their own risks by the Consolidated Supervised Entities (CSE) program, which ultimately failed. The flaw was that internal models overlooked the major risk of declining housing prices and the consequences for mortgage-backed securities, which led to their downfall. However it is not to say that SRO’s should become obsolete, instead their autonomy must fit into a larger system of co-regulation.

For effective implementation five principles are presented: reputational concerns of business, flexibility, autonomy and capacity of non-governmental regulators, transparency, and accountability. The guidelines for a framework of co-regulation attempts to resolve issues of compliance and enforcement. A highlighted matter is accountability, SROs should have statutory authority to have enforcement programs and ability to levy fines for firms that violate rules. In addition, the government should oversee private and quasi-public regulators with the capability to inflict penalties for violations. Public oversight and action by the state to enhance co-regulatory institutions would help to strengthen private governance and reinforce accountability within this integrated framework. The co-regulation approach provides a new way of understanding regulation that includes private governance such as SROs working with government to tackle issues of monitoring, enforcement and compliance to regulations.

"Embeddedness" in the Globalized Economy?

We live in a globalized world, meaning firms, businesses and even people are working in an international sphere and so capital is moving increasingly across borders. What does this mean for regulation both at a national and international level in a globalized context? How might markets and society be linked in this setting? *The Principles of Embedded Liberalism: Social Legitimacy and Global Capitalism* by Rawi Abdelal and John G. Ruggie advance an international perspective stemming from Karl Polanyi's thesis on "embedded" and "*disembedded" economies. The authors argue to "revisit principles of embedded liberalism*" (p. 151) by recognizing that the market economy is a reflection of society's political history, values and continuous interactions with it. The aim is to strengthen legitimacy and reconcile social goals with market dynamics that may enhance confidence in a global context.

To further the argument of legitimacy through embeddedness three cases are examined: transnational corporations (TCN), the international financial architecture, and international organizations. Firstly human rights and labour standards are analyzed for TCNs, as legal entities operating in a global economic landscape within different jurisdictions. With such a variation of rules and lack of a global regulatory framework, they have most times adopted their own private systems to regulate social and environmental performance. With such a myriad, the aim here is to revamp national regulations within a global context that creates a norm for self-regulatory organizations to commit to social values, thereby producing legitimacy effects. Moving on, the case for international financial architecture seeks to legitimize global capitalism through two methods. One is to balance the real economy with the financial sector, mainly by shielding the real economy from financial crises by use of public oversight. Secondly, to trust policymakers over financial markets in regulatory policies. Lastly, the case of international organizations such as the IMF or UN calls for the revival of multilateral solutions. The aim is to involve countries with growing economies into the discussion such as Brazil and China, and reconsider the skewed voting weight system in these types of organizations. In conclusion markets and society are interactive and the importance of legitimacy must be included in the regulatory framework. It might foster public confidence in market operations at an national and international scale.

Conclusion

New Perspectives on Regulation pools together a myriad of ideas from social disciplines as a stimulus to re-think regulation in the modern economy. It illustrates that the evolution of regulation requires the economics of regulation to be complimented by research in sociology, psychology and other social sciences. The central concern is how to optimise the regulatory system to meet both economic and social needs. It appears that most ideas reinforce the vision of the economy as "embedded", as a dynamic of social and market interactions. It must be considered the pervasiveness of economic reasoning in the regulatory process, specifically to consider how economics works in the real world. Scholar Michel Callon writes about 'performativity' as encountered in experimental economics. He explores the mechanisms that ultimately separate market from society, by conceiving the market as operating within its own domain and rules. Under economic assumptions, the question of how to reconcile the market with social goals remains a challenge for regulation in the real world.

The pillars of regulation are law and economics. While economic principles were readily contested such as the rational agent paradigm, matters of imperfect information and debated efficiency of unregulated markets, the legal perspective was overlooked. This is especially important when questioning enforcement mechanisms, where legal instruments are crucial. A law-based perspective might further the discussion to examine the role of lawyers and judges, and how they conceive of certain regulations. The aim should be to match market forces with legal underpinnings of regulatory processes. This can also advance the tools of cost-benefit analyses and position the role of government.

Historically changes to regulation are triggered by scandals and crises. The financial crisis of 2008 sparked such a debate and revealed issues such as inequality, information asymmetry and incentive structures. It cannot be overlooked that the economy and regulatory mechanisms are culturally contingent. Political and economic history are in-built in the scandals, and even more the institutions and agencies that deal with them. In reality it is not first crisis and probably not the last. Even new perspectives must take into account a culturally contingent framework deeply embedded in history. A comparative approach with the EU regulatory framework that consists of delegated agencies to deal with regulation in different areas notably systemic risk, prudential, and bank supervision might help to better understand what is rooted in the American system and what type of modifications are feasible. That is to say, a system cannot be overturned but slight modifications are necessary. Ultimately, it is a critical moment to retrofit regulation, to question what has been implemented and improved since the crisis. It might be that the doom of future crises will most likely unfold more loopholes that will require further adjustments, as regulation remains a continuous process ■

L'autre lion du Beffroi

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