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Regulation, Deregulation & Re-regulation

In the wake of the huge economic meltdown of 2008, which turned out to be the deepest dip since the Great Depression, there has been a widespread demand for a return to a regime of full-blooded regulation.

There are always two opinions about regulation.

"He who creates new laws increases sorrow" says the old proverb – and critics always stress that there are inevitably costs and injustices. And since regulation may mean numerical limits being placed on certain commonplace activities, the critics also often berate economic regulation as arbitrary and stupid.

On the other hand, supporters claim that the choice is really between anarchy and "Freedom-under-Law", and that when it comes to counting consequences, regulation may prevent more harm than it causes.

And they like to quote Mr Justice Holmes who used to say: "The Life of the Law has not been Logic – it has been Experience". So its supporters concede that regulation may be intellectually shallow, but they say that its virtue is that it is effective.

It is always true that there is strong spontaneous demand for regulation from the broad public. Crises often seem to start with shady or criminal activity. Why should economic malfeasance be treated any differently from other forms of crime? Does anybody want to advocate deregulating murder? But perhaps the strongest argument for returning to a regime of strong regulation is precisely a special form of the argument from experience, namely, the argument from history.

The thirty years after World War II, which the French call the 30 glorious years, and others call THE GOLDEN AGE OF CAPITALISM, were years of high regulation. Because people were saying "Never Again" about the Great Depression, financial institutions were tightly controlled and there were also major constraints on international movements of capital.

Consequently, there were few crises of any kind, no major banks failed and there weren't too many examples of sovereign financial difficulties either.

Did people have to pay for this stability?

Probably, yes: some transactions were more expensive, and some people had to pay more for capital. Less obviously, there may have been less financial innovation than in the free-wheeling Reagan years. But not all financial innovation is a good thing:

novelties increase complexity, and lead to the proliferation of fraud and the defense against this is more fees and more financial advisers. Arguably, the financial sector has become bloated in recent years.

Normally we assess welfare directly by concentrating on wealth and income.

But in terms of growth and distribution those 3 decades were years of truly magical performance. Steady growth and rising productivity were almost immediately translated into high wages, and the resulting redistribution steadily narrowed the gap between rich and poor. It was a regime of high incomes, high taxes and high investment in public goods.

The striking thing is that the official purpose of postwar regulation was only stability, but in fact for reasons which are not at all well understood, the regime of strong regulation had all sorts of unintended consequences which were almost wholly beneficial.

There is a deep-seated irony here: in the inter-war period and again, recently, people who loved capitalism came close to destroying it; while the skeptics, (New Dealers and Social Democrats) who wanted capitalism kept on a leash, were showered with bounties as if from an invisible hand.

Now some of the problems besetting the functioning of capitalist institutions have been known about for a long time. For example, there is the question of limited liability. Originally most businesses were partnerships where the owners had no limitation on liability if things went wrong. When incorporation with limited liability was introduced in the 19th century, the Free Marketeers of the time denounced this as undermining capitalism 'as we know it'. They were not wrong, for since the 19th century it has become clear that in certain circumstances limited liability can indeed result in owners pushing the costs of excessive risk-taking onto other people. But under conditions of dispersed and weak ownership this problem is rare: for in the 20th century a second set of problems has emerged. Since the 1930s it has been clear that executive directors or managers can become a law unto themselves, and the principal external restraint on management, the take-over mechanism, is generally weak and ineffective in enforcing safety, discipline and accountability. This does not mean that management always gets its own way and behaves irresponsibly, for there can be countervailing powers vested in unions, big customers, junior management or regulatory authorities. But multiple pressures can themselves make for a less-than transparent environment, and we come back to recurrent problems of securing prudence and integrity among top decision-makers.

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Fraud can be pursued by legal action in the courts, although this too can be a slow and tortuous process. More seriously, leverage can mean that transactions undertaken in good faith will go rotten in a crisis. The market does contain self-correcting mechanisms but in a crisis they are as likely to hurt the innocent as they are to punish the guilty. Lehmann Brothers cooked its books and was ultimately destroyed, but a lot of other businesses were shaken up and faced problems of credibility once it became clear that Lehmann Brothers had managed to pull the wool over the eyes of the ratings agencies. More generally, the investing public are likely to hang back when it seems that nothing has changed and their money is still liable to be nibbled away by sharks. Consequently, some sort of regulation begins to look very attractive. The choice seems to be one of what sort of regulation?

Different problems yield to different kinds of regulation, some easy, some difficult. Some of it is magic numbers stuff, setting higher margin or reserve requirements for example. Some of it is about making sure that institutions are clear about their identity and separate out different functions and services. (Benjamin Friedmann jokes about Harvard having become a hedge-fund disguised as a University.) Veteran leader of the Fed, Paul Volcker, has been particularly keen on this. Simple banking services should be separated from those which involve risk or advocacy.

Likewise it is important to distinguish activities which are speculative, and multiply risk, from those which are like insurance, and reduce it. It is also important to have separation where there is a possible conflict of interests. (It was not very edifying when Goldman Sachs helped Greece to cook its books and then took out bets against that country.)

But some of the new push to regulation is also about improving information and imposing better reporting and accounting standards. (Only Mr Berlusconi wants to decriminalise dishonest book-keeping.) This is the least onerous kind of regulation, and has plenty of precedent stretching back four hundred years.

Many members of the public have been deeply incensed by the spectacle of top executives wreaking havoc while taking home huge bonuses. This fuels popular and populist demands to regulate salaries.

But then we also seem to face some problems which are new. One is about the growth of inequality within firms. Many members of the public have been deeply incensed by the spectacle of top executives wreaking havoc while taking home huge bonuses. This fuels popular and populist demands to regulate salaries. In fact, this may be a case where the popular response is onto something deep. For students of industrial organisation have known for a long time that inequality often goes with dysfunctionality. Dan Ariely, the Israeli-born psychologist who now teaches at the Sloan school of Management at MIT, has recently argued that the *Yerkes-Dodson* Law, a well-confirmed classic from the study of animal behaviour means that incentives only work if they are small. It is easy to understand why harsh punishments generally fail: the animal gets paralysed with fear – but understanding why large rewards don't work is less intuitive. In the case of business executives, one possible explanation may be that excessive pay packages encourage excessive effort. It is in the interior of large firms that Jefferson's maxim applies most forcefully:" He governs best, who governs least" – micro-management is almost universally acknowledged to be bad management. (It is an interesting question why we have not seen emerging a market solution to this problem – that is the spontaneous emergence of firms whose CEOs are appropriately income-constrained.)

Another problem that is new, and which may provoke regulatory efforts which are inappropriate (either too weak or too strong or too much of the wrong thing) is the worry about Institutions which are 'too big to fail'.

In addition to the New Deal legislation, which aimed at stabilising the financial industry in the golden age, America has a long tradition of populist regulation in

Anti-Trust, trying to cut down the big trees. Some of this has undoubtedly been misguided – going after firms which are super-efficient or which enjoy economies of scale. It has been well-said that Anti-Trust has been America's substitute for Socialism. The European Left put a lot of effort into trying to manage natural monopolies, while Americans recruited lawyers to go after big companies – whether monopolies or not – pursuing them either by litigation or by administrative fiat.

And yet the issues here are very complex: economic historians have sometimes discerned a cloud with a silver-lining. Firms which are threatened by Trust-busting can occasionally respond by 'thinking out of the box', and innovating in unexpected ways. Yet it has been argued that this did not happen with railways: Regulation killed dynamism in the American railway system, and that is why American rail transport lags behind that of Europe and Japan.

It is here that one must expect the debate about regulation to be at its most intricate. There are intellectually tough questions involving both technology and economic organisation.

But of course the issues here are not just intellectual arguments. They are also sometimes questions of culture and ideology, and above all, questions frequently of political will.

Thus the initial steps of the Obama administration to stabilise the situation, by offering a bail-out to the banking sector, seems in retrospect, a weak response. If they had been tougher they might well have followed the precedent set twenty years earlier when President and Congress tidied up the mess which had been created by the crisis over Savings and Loans. Troubled firms would have been seized and reorganised, reckless bank-managers fired, shareholders punished for negligence, and creditors forced to take a 'haircut' – i.e. a delay or reduction in repayments.

The second decade of the twenty-first century looks increasingly like a quagmire. Dynamism in the world economy must depend on Asia.

But instead, as Nobel Prize-winning economist Joseph Stiglitz put it, what the Obama administration did was "far worse than nationalization: it was ersatz capitalism, the privatizing of gains and the socializing of losses."

And there may be more weakness in store for us. The sad thing is that America has moved so profoundly to the right, that the Obama administration is very likely to lose steam or have its reform efforts sabotaged by members of its own party. The Europeans are marginally more united on the side of reform, but because of the misadventures of the single currency they may also be unable to get the train of re-regulation back on track for quite some while yet. The second decade of the twenty-first century looks increasingly like a quagmire. Dynamism in the world economy must depend on Asia.

And what of South Africa?

So far we have had very little sign of creative thinking. We do not have either the European tradition of Social Democracy or the American tradition of Anti-Trust.

We have some pragmatism – which is no doubt a good thing – and enough conservatism to ensure that our oligopolistic banking industry may be both needlessly expensive and relatively safe. But currently the financial services industry seems to be in some turmoil for various other reasons, and one wonders what insiders think.

Some concluding remarks

Regulation has often in the past been the product of practical men worried about instability, and trying to reach workable compromises under difficult circumstances, whereas deregulation, though it too can be pragmatic – moving one step at a time – is often embraced by theorists in a doctrinaire way because of its theoretical neatness.

But there are other perspectives. Nowadays one must mention names like that of the Columbia economist the late Hyman Minsky and the founder of the Quantum Fund, George Soros.

Neither of these gentlemen have taken the view that the return of market instability is a simple consequence of the ascendency of Market Fundamentalist economists during the Reagan/Thatcher years, much as both of them deplored that kind of economics. Soros thinks of regulation and deregulation as stages in a long war, where offensive and defensive tactics are alternately dominant. Nor is it a simple war of the private sector against the State, for different enterprises are differently situated in relation to regulation, and wily entrepreneurs can set things up to their own advantage.

Minsky adopted a similar philosophy which sees the game of regulation, deregulation and re-regulation as an eternal dance, or, one might say, an eternal dialectic. For in his eyes it is safety itself which leads to complacency, and ultimately to the renewed demand to do high-wire acrobatics without a safety-net.

So, we must be warned, the question of regulation is a thorny one, and simple answers are almost always wrong answers.

NOTES

1 See, for instance: Barro, Robert. (1991). Economic growth in a cross-section of countries. The Quarterly Journal of Economics, 106 (2), pp. 407 – 443; Castello, Amparo & Rafael Domenech. (2000). Human capital inequality and economic growth: Some new evidence. Unpublished manuscript; Castello-Climent, Amparo. (2008). On the distribution of education and democracy. Journal of Development Economics, 87, pp. 179 – 190.

2 Barro, Robert. (1999). Determinants of democracy. The Journal of Political Economy, 107 (6), pp. s158 –s183; Benavot, Aaron. (1996). Democracy and political democratization: Cross-national and longitudinal findings. Comparative Education Review, 40 (4), pp. 377 – 403.

3 There is a strong cross-national correlation between democracy, high levels of GDP per capita, and measures of national education. Explaining this correlation using educational institutions as a mechanism is the current focus of my research.

4 Mattes, Robert & Dangalira Mughogho. (2010). The limited impacts of formal education on democratic citizenship in Africa. Paper prepared for HERANA.

5 Acemoglu, Daron & James Robinson. (2006). The Economic Origins of Dictatorship and Democracy. Cambridge: Cambridge University Press.

6 Przeworski, Adam. (1986). Capitalism and Social Democracy. Cambridge: Cambridge University Press.

7 Caplan, Bryan. (2007). The Myth of the Rational Voter. New Jersey: Princeton University Press.

8 Note, Caplan is concerned with economic knowledge, but asserts that in other fields his arguments may hold equally well.

9 Delli Carpini, Michael & Scott Keeter. (1996).What Americans Know About Politics, and Why it Matters. New Haven: Yale University Press.

10 Fedderke, Johannes, de Kadt, Raphael & John Luiz. (2000). Uneducating South Africa: The failure to address the 1910 – 1993 legacy. International Review of Education, 46 (3-4), pp. 257 – 281.

11 Bhorat, Haroon & Ravi Kanbur (eds). 2006. Poverty and Policy in Post-Apartheid South Africa. Cape Town: HSRC Press.