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Creating Competitive Markets: The Politics of Market Design

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Creating Competitive Markets should be read, in part, as a cautionary tale. Although we strongly support the use of government to promote market competition, many market reforms we analyze have had checkered results. The privatization of British pension funds launched in 1986, for instance, failed entirely. The U.S. decision to end subsidies for major agricultural commodities under the Federal Agriculture Improvement and Reform (FAIR) Act of 1996 was rescinded after a few years. Changes in telecommunications policy also enacted in 1996 have had at best an ambiguous competitive impact. And the political momentum pushing for greater pro-competitive policy has weakened. The opening up of electricity markets to greater competition in the 1990s, once considered the wave of the future, also met with mixed results. This is in stark contrast to the earlier and highly successful wave of "deregulations" of trucking, airlines, railroads, and telecommunications that took place during the 1970s and early 1980s.

A cautionary tale need not be a pessimistic one, however. Despite the sobering lessons of the second wave of marketization policy reform that our book presents, greater success is possible—but only if policymakers fully appreciate and face up to both the political and analytical difficulties of creating competitive markets.

Deregulation and Market Design

For the first two-thirds of the twentieth century, it appeared that the nineteenth-century dream of free markets was being subjected to a rude awakening. Communism had rejected the market throughout much of Asia and Eastern Europe. Government ownership and public provision of goods and services had become a major force in the democratic nations of Western Europe as well—even in the birthplace of free enterprise, Great Britain. Although the United States was less affected by the anticapitalist turn, the dominant trend since the rise of Progressivism in the early 1900s had been toward stricter and more interventionist regulation and control of many economic sectors, including trucking, airlines, telecommunications, banking, power production, agriculture, health, and finance. In the early 1970s there was scant evidence that a worldwide pro-market counterrevolution was about to get under way. Yet by the dawn of the new millennium every alternative to markets—from communism to democratic socialism to command-and-control regulation—was on the retreat around the globe.

In the United States, pro-market public policy took the form of what is conventionally called "deregulation." A wave of deregulation hit aviation, trucking, and telecommunications in the mid-1970s, stimulated by an intellectually powerful and persuasive body of writings from experts in influential economics departments, law schools, and think tanks. In 1985 the Brookings Institution published a seminal account of this phenomenon, *The Politics of Deregulation*, by Martha Derthick and Paul Quirk. During the more than two decades that have elapsed since then, almost every heavily regulated sector of the economy—including banking, agriculture, telecommunications, and energy—has experienced serious reform aimed at improving economic performance by removing the dead hand of regulation and increasing competitive pressure.

Inspired by the pioneering work of Quirk and Derthick, this book takes up where they left off, just as public policy had begun questioning the previous era's rhetoric of disciplining and taming markets. This book examines what is now a thirty-year history of policy innovation dominated by a rhetoric of freeing up competitive forces and replacing flaccid and cumbersome government intervention with the flexibility and creativity that markets are supposed to stimulate.

Central Findings

This book contains seven central findings. First, policy affects market competition on two distinct levels: macro and micro. Second, efforts to create competitive markets do not deregulate; they redeploy regulation. Third, the track record of regulatory redeployments to date is highly uneven, with at least as many failures as successes. Fourth, success can best be fostered if policymakers abide by the following policy design principles: provide risk protection on a *macro* not a micro level, accept the constraints imposed by imperfect knowledge, and limit the ambition of the market design. Fifth, failure to produce more competitive markets is due to complex mixtures of cognitive and political constraints; indeed, the single greatest impediment to successful marketization policy is the sheer amount of political interference in the market design process. Sixth, increased market competition is greatly facilitated by Schumpeterian "creative destruction," which occurs when technological innovations destroy existing oligopolistic barriers and facilitate market entry or when intrusive regulatory agencies are abolished. Whatever the mechanism, creative destruction has positive effects by reconfiguring interest group dynamics to facilitate the formation of a powerful new political coalition that supports the new pro-competitive policy regime. Seventh, the way for policy designers to cope with political constraints and formulate successful policy design is to adopt a more self-consciously political understanding of their roles. To enable the "invisible hand" of the market to gain a foothold and to flourish despite the onslaughts of rent seekers, they need to apply a noninvisible hand—a political hand—that will help them anticipate and stave off political obstacles.

Macro Policy

The role of public policy in promoting competitiveness is by no means limited to intervening directly in the design of particular markets. As discussed in the first part of this book, macro policies that are not market specific may establish or fail to establish the necessary and complementary conditions for sustaining a competitive economic environment. Such macro policies include insurance and other forms of risk amelioration, welfare and health policies that affect labor mobility, corporate reform, and other government policies and programs aimed at creating sufficient levels of security and transparency to encourage individuals and firms to live by market outcomes.

We use the term "macro policy" to draw attention to the broad frameworks in which markets operate. It flags a key question of this discussion: how and why do actors in a particular market system accord it sufficient legitimacy to actually live by its outcomes rather than seek to undermine and destroy it. The term also encourages an appreciation of the relationship between a cultivation of the norms of trust, efficacy, and legitimacy, on one hand, and the design of a particular pro-competitive system, on the other. In this volume, John Cioffi explores that relationship by considering how changes in corporate governance under the Sarbanes Oxley Act of 2002 are likely to affect the public's trust in corporate behavior and thereby its willingness to continue to invest in corporations, whether the reform gives firms relatively free rein to control their own affairs, and to what extent it refrains from interfering in how they compete with one another.

Likewise, Martin Shapiro investigates the dangers that stem from undermining public faith in corporate good behavior. He looks at the relationship between governmental efforts to create greater economic competition and the resulting incentives to both the regulated and the regulator. Shapiro concludes that the doctrine of self-interest central to free market competition does not encourage playing by the rules. Hence a free market economy depends upon rigorous policing to prevent unfair practices. But recent salutary trends in regulatory reform designed to remove the "dead hand" of command and control undermine the government's ability to police the private sector, not to mention itself. Efforts to ease monitoring problems, encourage voluntary compliance, and negotiate settlements of regulatory violations rather than insist on immediate and complete remediation or punishment undoubtedly remove obstacles to greater competition and more efficient operations. By removing a whole series of blunt enforcement instruments, they also make it much easier for the regulated to evade the spirit of a reform. It then becomes easier to cheat, harder for the regulators to catch cheaters, and easier for reluctant regulators to avoid catching them. Further incentives to cheat are provided by the massive amounts of money funneled into corporations by today's highly efficient stock market, bending behavior far beyond the typical levels of corporate fraud. Shapiro's analysis of these dangers speaks to macro policy at the broadest conceivable level—at the interaction between economic efficiency, trust in government, and justice.

This book's discussion of macro policy has its roots in early discussions about the impact of risk protection on economic efficiency and innovation. A positive view, eloquently expressed by the renowned economic anthropologist Karl Polanyi, is that government is the crucial vehicle for tempering and softening the profound dislocations associated with a dynamic economy. In *The Great Transformation,* Polanyi explains how the advent of the welfare state enabled citizens to cope with the destabilizing effects of the Industrial Revolution and its aftermath.[1] Absent government tempering and disciplining, Polanyi claims, the entire capitalist enterprise would have imploded.

Micro Policy

The second part of this book focuses on "micro policy," the specific policy designs created to address perceived inadequacies in the regulatory regimes governing specific economic sectors. The term "deregulatory" does not adequately convey the nature of the micro policies described in this book. A more appropriate term for policies that ostensibly aim to increase private competition in a specific market realm is "market design." This is not merely a semantic quibble. Market design initiatives, successful or not, embody rules and regulations that are often at least as numerous and complicated as those they displace. Indeed, our chapters show a striking interpenetration of politics and markets. The traditional distinctions between government and market and between public and private do not apply to the processes of market design and redesign that we found to be at the heart of creating competitive markets.

The absence of literal deregulation is evident in all of our case studies. Banking, securities, and telecommunications provide especially striking examples of how efforts to stimulate competition result in ever more complex and numerous government strictures. Even if these initiatives have stimulated competition, nothing resembling complete deregulation has in fact taken place. Instead, the government has changed the nature of its involvement in order to make use of laws and policy designs establishing a pro- rather than anticompetitive institutional framework. Rather than deregulating, public policy has been self-consciously fashioning—or as Eric Patashnik puts it, reconfiguring—markets so that they will exhibit particular and contingent features. One of the primary goals of our analysis is to determine the extent to which these frameworks and features promote the pro-competitive goals they were ostensibly designed to foster.

The regulatory redeployments described here come in many guises.[2] Some are fundamental to any effort at market formation, beginning with clearly defined property rights. Likewise, sanctions must be imposed on those who violate the norms of honesty and transparency on which market systems depend. To discourage fraud and deception, measurement must be accurate; information provided by the buyer must be true, and the payment provided by the seller must be genuine and timely. To this end, Cioffi points out, the Sarbanes Oxley Act established new forms of liability for chief executive officers, chief financial officers, and corporate boards of directors. Regulation in the form of antitrust rules and mandated consumer information may also be necessary to cope with certain market imperfections that competition cannot cure and may even magnify. As Frederick Hess shows, state education departments are struggling to make sure parents are adequately informed about the charter schools licensed to compete with ordinary public schools.

Making a new market is a much more subtle and complex regulatory task than maintaining an existing one. More intrusive rules may be needed to stimulate competitive behavior where it did not previously exist—an idea that Steve Vogel captures with the term "asymmetric regulation," in reference to regulations designed to impose restraints on incumbents and give advantages to potential competitors. Alan Jacobs and Steven Teles illustrate this concept in pension privatization in Britain. When privatization began in 1986, there was no market of individualized retirement savings vehicles for workers. The few products that did exist were designed for a small group of the self-employed and wealthy. The government sought to stimulate the creation of a broader market by proposing that holders of personal pensions be given a rebate on their National Insurance contributions (which then flowed into their occupational scheme, if they had one), and that contributions to personal pensions be deferred, just like contributions to occupational schemes. In addition, the government boosted returns on privately purchased pensions above the actuarial baseline.

Any such changes in the rules of the competitive game, despite the fact that they are meant to improve efficiency, will inevitably punish some competitors or some consumers, or both. Therefore new rules are likely to include some form of direct compensation, grandfathering, or other means of benefiting those who have been harmed. If benefits are difficult to define, Darius Gaskins notes, market designers may face great political obstacles, as those in the electricity sector do because they cannot guarantee in advance that the changes they propose will always produce lower prices. In the airlines case discussed by Michael Levine and Eric Patashnik, Congress had to establish a program of side payments in the form of regional and other subsidies to those interests whose opposition had to be neutralized if the reform was to be adopted.

Technological Innovation, Government, and Competitive Success

Our studies focus largely on micro efforts to create competitive markets and macro efforts to undergird and sustain them. But we recognize that in some instances the most important influences on particular markets may not be those micro or macro policies, but rather an exogenous force such as technological innovation. Regulation has repeatedly proved unable to stifle innovation. For example, tight regulation of railroads by the Interstate Commerce

Commission (ICC) may have slowed the growth of competition in the transport sector but did not prevent it. Technological innovation in the form of trucks, automobiles, and airplanes placed relentless pressure on railroads to lower rates and improve service.

The best example of the impact of technological change is in telecommunications, which has seen greater price declines over time than any other economic sector discussed in this book. As Andrew Rich explains, telecommunications competition increased *despite* the Telecommunications Act of 1996, as a result of a technological development ignored by the act—cellular telephony. This technology dates back to the 1970s, when new telecommunications entrants such as MCI and Sprint developed novel alternatives to AT&T's reliance on landlines.

Although such innovation is exogenous to the policies this book considers, its success was dependent on prior government action. Neither Sprint nor MCI could have entered the long-distance phone market if not for the successful suit brought by the Justice Department to end AT&T's monopoly. The settlement forced AT&T to allow competitors to purchase space on its landline facilities. Without this court-imposed toehold, these dynamic innovators would not have had the chance to explore the technological alternatives to landlines that proved to be the precursors to the cell phone industry.

Successes

As mentioned at the outset, public policy's performance in creating competitive markets has been quite mixed.[3] Among the successes, deposit insurance has had a very salubrious effect on the efficiency of banking, as Jonathan Macey shows. Although the returns are not yet in, innovations under the Sarbanes Oxley Act emphasizing structural reform rather than litigation-driven enforcement are expected to diminish accounting and securities fraud and enable the capital markets to function more efficiently, says Cioffi. In transportation, airline and railroad regulatory policy changes were instrumental in increasing competition in the American market, as noted in the chapters by Darius Gaskins, Michael Levine, and Eric Patashnik. Edward Iacobucci, Michael Trebilcock, and Ralph Winter found similar results in Canada. In electricity, reforms adopted by the Pennsylvania, New Jersey, and Maryland Regional Electricity Pool (PJM) worked to decrease electricity rates, report Richard O'Neill and Udi Helman. And in agriculture, the 1996 FAIR Act gave farmers greater freedom to decide what and how much to plant, Patashnik points out.

Failures

Cioffi describes a failure that predates the Sarbanes Oxley Act: Congress's failure to protect the integrity of the private auditing process led to flagrant fraud, which in turn caused the collapse of Enron and other major corporations. Vogel discusses how the Japanese practice of employment security diminishes labor market mobility. As Shapiro shows, recent trends in regulatory reform designed to remove the "dead hand" of command and control, such as negotiation and soft law, have in some cases undermined the government's ability to police both the private sector and itself. In the examples he cites—including railroads—this resulted in less efficient and less safe market behavior. Some other failures are Congress's inability to sustain the abolition of farm price subsidies, passed in1996 (see Patashnik's discussion); the weak outcome of school choice proponents (described by Hess); and California's failed effort to create a competitive electricity market (see the chapter by O'Neill and Hellman). In Canada, as Iacobucci and his colleagues point out, the effort to open up Ontario's electricity market was short-lived, and the marketizing of telephony throughout the country, though by and large successful, ran into problems when the regulatory commission tried to maintain price floors for certain services. In the United States, the 1996 Telecommunications Act left the marketplace unimproved for consumers, concludes Rich, and eliminating certain forms of regulation led to the very costly savings and loan (S&L) debacle, argues Macey.

As noted earlier, a particularly striking failure befell the British experiment in privatizing pensions, which began in 1986. Its threefold objective was to protect the public purse, reduce collectivism in the public sphere, and increase labor mobility in the private sphere. But as Jacobs and Teles show, the outcome was rampant "mis-selling"—fraudulent or nearly fraudulent representations—of private pensions. In response, the government passed the Pensions Act of 1995, which imposed unprecedented regulation on the private pensions market.

As also pointed out, the sparse success of marketization during the late 1980s and 1990s stands in stark contrast to the virtually uniform success of the 1970s and 1980s. This contrast suggests that the earlier successes may relate to "low-hanging fruit": government-created oligopolies were ripe for the plucking because the rationale for suppressing competition had long since disappeared, and new entrants were available that were both able and eager to compete once regulatory barriers were removed. The question remains, however, as to why they were harder to marketize in the later period. Our ambitious task is to answer this question.*

The Politics of Market Design

Clearly, competitive markets are not as easy to achieve as proponents suppose. The hope was that once a policy realm was "deregulated," it would become permanently depoliticized as rent-seeking competition in the political realm would be largely displaced by economic competition in the marketplace. Nor does a neutral set of competitive rules necessarily mean that self-interested parties will rest content to play by the rules. To be sure, the first wave of deregulation provided some support for proponents' expectations. In *The Politics of Deregulation,* Quirk and Derthick found that in the policy spheres of trucking and airlines, at least, old-fashioned rent-seeking politics had been blunted by a new politics dominated by congressional and bureaucratic policy entrepreneurs and academic experts. And in our earlier book, *The New Politics of Public Policy,* we extended this insight to such diverse policy arenas as taxes, the environment, and immigration.

By contrast, *Creating Competitive Markets* finds that old-fashioned group-based politics never died away. Indeed, political interference of that nature—and policymakers' failure to anticipate it—is probably the strongest single reason that policy reform failed to promote competition. For example,

*As Peter Schuck suggests in the last chapter in this volume, the conditions associated with these successes and failures are manifold, the phenomena analyzed "are dauntingly complex" and at times even opaque. Of the many conditions that Bardach finds associated with these outcomes, he explores only one: "when policymakers have high stakes in deregulation . . . , their actions often lead, directly or indirectly, to failure." Similarly, Schuck only comes up with one generalization: "politics pervades not only the forms of market design . . . , but also the[se reforms'] substantive content. . . . Beyond this . . . each of our case studies reveals a stubborn singularity." Schuck concludes that this will be frustrating to "lumpers" yearning for theoretical elegance and predictive power, because we are left "without powerful predictive formulas . . . [and are reminded that] a satisfying explanation of public policy outcomes depends on many factors that are difficult to characterize and highly specific to the individual case. Once again, the splitters win." Thus both eschew our more ambitious mission. While we agree that political factors are the most powerful condition shaping these outcomes, additional crucial conditions must also be taken into account, particularly the extent of political interference in the market design process; the extent of the presence or absence of government institutions that regulate, subsidize, or directly provide services; the nature of the interests involved and the extent to which they have been reconfigured in a direction that supports the new deregulatory regime; the extent to which market forces induce creative destructiveness; and the extent of technological innovation in the particular broad business sector.

according to a prominent participant, the designers of airline deregulation in the 1970s did not anticipate that a decade later the Reagan administration would, in effect, "close down the Anti-Trust Division of the Justice Department," permitting airline firms to indulge in anticompetitive behavior (predatory pricing, mergers), which led to overconcentration and inefficiency in the industry. This otherwise sagacious policymaker had unrealistically assumed that opening up markets would be a game played according to Marquis of Queensbury rules. In fact, players always feel free to change the rules to their advantage.

Thus market design reform did not mark the "beginning of the end" of governmental involvement and political conflict over economic regulation. Rather, to borrow from Winston Churchill, it marked the "end of the beginning" of a new twist on the old politics. Efforts to gain competitive advantage now have to be cloaked in new and subtle free market rhetorical and institutional garb. But rent-seeking objectives remain very much the same.

Not recognizing that the politics of rent seeking was still in full swing, marketization advocates failed to adequately understand the political implications of and political influences on their policy reform objectives. They were too apt to view marketization in principle as marketization in practice, expecting the magic of the market not only to reconcile supply and demand but also to turn nasty rent-seekers into fierce but punctilious competitors cheerfully abiding by market rules. One is reminded of the old Soviet-era joke that capitalism is the exploitation of man by man and communism the reverse. In the world of regulatory politics, that translates as old-fashioned regulation pits interest group against interest group while market design policymaking does the reverse.

Ronald Coase once observed that the real choice in determining how best to achieve economic efficiency is between imperfect markets and imperfect regulators. Friedrich Hayek, champion of free markets, argued further that it is very hard for markets and regulators alike to attain efficiency, but harder for regulators. Our chapters force market advocates to squarely face the significant political obstacles to designing market mechanisms that actually live up to the theoretical potential to which the likes of Coase, Hayek, and Charles Schultze aspire.

The cases described in this book are political in every sense: they stir partisan passions, spark intense ideological struggles, involve complex bargains and compromises, and mobilize diverse political coalitions. And they show that rent seeking is more cleverly disguised in today's world. Thus it might be better to reword Coase's adage: the choice is no longer between imperfect markets and imperfect regulators, but between imperfect regulation and imperfect deregulation.

The new version of rent seeking is evident in many of our cases. Congress, Patashnik points out, was eager for political advantage in 2002 when it reinstated the price subsidies so popular with most farmers and their trade associations. California's effort to deregulate electricity discussed by O'Neill and Helman demonstrates that even if experts help design policy, they may not be impartial. The consultants and expert witnesses in this case were chosen for and by a state legislature that had been successfully lobbied by Enron and various other energy and investment companies. By cloaking their preferred policies in the free market rhetoric of hired experts, these rent seekers promoted inefficient market design that maximized their capture of transaction cost profits. Significantly, many economists who were not asked to testify before the legislature were skeptical of the market design proposals precisely because of their flaws.

Another flawed market design with political roots, described by Macey, was that advocated by the "Keating Five": Senators John McCain, Alan Cranston, John Glenn, Dennis DeConcini, and Don Reigle, who all received large campaign contributions from S&L executive Charles Keating. As Rich points out, the passage of the Telecommunications Act of 1996 was yet another throwback to the "old" politics of public policy. The "Baby Bells," facing the loss of their oligopolistic rents, aggressively lobbied Congress and the Federal Communications Commission (FCC) to preserve their advantages. Their champions, such as Senate Majority Leader Robert Dole and Senator Ernest Hollings, vociferously defended policies designed to insulate companies based in their home states from competition. Cloaked in the language of marketization, the resulting legislation placed barriers in the path of new entrants, especially smaller, more technologically oriented companies.

Consumers, argue Iacobucci and his colleagues, can also play a strong political role in blunting competitive market design. When electricity marketization in Ontario failed, consumer backlash was instrumental in bringing about re-regulation. Their Canadian analysis as well as that of Jacobs and Teles on U.K. pension reform and Vogel's on marketization in Japan demonstrate that much is to be learned from comparing policies across countries.

Until recently, however, many U.S. analysts ignored this broader perspective and "comparativists" ignored the United States. This tendency was due in large part to the organization of political science. For a long time, "comparative politics" referred less to a method of inquiry than to a category of study, namely, the politics of some country other than the United States.

Since the late 1990s, however, "comparative" has come more often to be taken seriously and refer to inquiries into the ways that different countries, including the United States, respond to similar policy problems. We include this kind of discussion in the hope of stimulating both Americanists and comparativists to widen their intellectual and empirical horizons, in the tradition of our earlier *Transatlantic Policymaking in an Age of Austerity* and that of other truly comparative policy analyses, such as Pierson's, Hall's, David Vogel's, and Steven Vogel's.[4]

Of course, the role of the government itself in marketization must not be overlooked either, as Eugene Bardach emphasizes. The depth of governmental organizations' and actors' stakes in the outcome of market-oriented reform vary from policy to policy. Bardach argues that, perversely, the greater the government's perceived stakes in a particular innovation, the more likely that design is to fail.

Eric Patashnik's fine chapter, "The Day *after* Market-Oriented Reform," reveals today's rent-seeking dynamic—"what happens when economists (reform ideas) meet politics." Much of this book centers on what occurs when economists' ideals meet the realities of the highly political market design process.

Cognitive and Political Constraints

In *Transatlantic Policymaking in an Age of Austerity,* Martin Levin and Martin Shapiro underlined the great importance of cognitive constraints in limiting policy success. They found that for many of Europe's and America's complex socioeconomic problems, no expert consensus existed for solutions.[5] Health care, for example, is rife with severe disagreements about how to resolve the tensions between cost containment and adequate access to care. Describing these cognitive complexities, Jacob Hacker observes: "Medical industrial complex leaders are caught between fiscal constraints and public demands . . . with competing evaluations and prescriptions, and embroiled in bitter struggles in which questions of equality, justice, professional sovereignty, the role of markets, and indeed life and death are never far beneath the surface."

Regulatory policies, including regulatory redeployments, are inherently more difficult to conceive and implement than distributive policies (building a highway, for example) or redistributive ones (transfer payments, for example). In the regulatory realm, policymakers cannot act directly to hire building contractors or write a check to recipients. Instead, they must cause others to act, often through indirect means. When British policymakers privatized their pension system, they were well aware that few private suppliers were poised to provide pension schemes. But because they *needed* such suppliers for the reform to work, they assumed that once erected, a private scheme, like the mythical baseball stadium in *Field of Dreams,* would bring many in.

Cognitive difficulties can compound political problems, as is vividly illustrated by California's experience with electricity. From the outset, policy designers faced imponderable or at least uncontrollable factors, such as the price of oil and the amount of rainfall, on which hydroelectric power production depends. To add to their concerns, political factors suggested that a truly free market in electricity might create prices that consumers would consider too high. Citizens and legislators alike so mistrusted the utilities that when the latter sought to have consumers pay for the billions of dollars of "stranded costs" due to failed or incompetent construction of generating facilities, the state legislature agreed to this bailout only in exchange for a cap on retail rates, even though wholesale rates were allowed to float with the market. When wholesale prices rose unexpectedly, electric utilities, unable to raise retail rates, spiraled into bankruptcy. The inability to predict wholesale prices, a cognitive constraint, combined with the political constraint on raising prices, produced an energy policy fiasco.

Fostering Success

Despite all the problems that our cases depict, many positive lessons emerge about how to foster success at both the macro and micro levels. A particularly important one is that policymakers must pay close attention to the political sustainability of efforts at regulatory reform.

Coping with Risk through Macro Policy

The analysis of macro policy in part one of this book tends to support Polanyi. For example, Vogel's observations on Japanese social policy support the Polanyian belief that governments need to keep individual risk levels to manageable proportions in order to sustain markets. One large obstacle to marketization in Japan, many argue, is its poor unemployment insurance system, which would be unable to cope with the politically unacceptable labor dislocation and unemployment likely to ensue from increased competition. In other words, says Vogel, "in the Japanese context anticompetitive regulation *is* a critical component of the social safety net."

Because Japan provides such meager social insurance, its citizens look to specific sectors of the private economy for job and income security. This stultifies the labor market and makes it very difficult to introduce competitive principles into these sectors. Perhaps the most effective means of increasing their competitive efficiency would be to decouple social insurance policy from employment and thus enable the labor market to function more freely.

Macey's finding suggests an important refinement to the Polanyi-Vogel argument in banking, where an additional concern is how protection is provided. Two forms of risk protection are available to banks—deposit insurance and bailouts of failing banks—and both create moral hazard. If a depositor is insured, that individual has no incentive to exercise oversight over how his or her money is being lent or otherwise invested. Likewise, if a bank has a reasonable hope of being bailed out if its loans go bad, it has a greater incentive to make high-risk, high-return loans. However, these two forms of moral-hazard-inducing risk protection do not produce the same result. Bailouts, Macey shows, have a far more deleterious effect on banking efficiency than does deposit insurance.

Although economic theory suggests that competitiveness and efficiency should be addressed separately from fairness and equity, in the political world all these issues are inevitably conflated. Those who find themselves worse off in a competitive environment fight for assurances of protection. For the public, fairness and equity generally have a higher value than the promise of efficiency does. Therefore the critical policy design question regarding equity and efficiency relates to how, not whether, it is provided. Indeed, one of the most critical determinants of regulatory success or failure is whether equity and risk protections are part of macro policy or are directly incorporated into market-oriented policy reform. Equity remedies that are built into market design—such as price controls and rate-setting regulations for electricity and telephone services or Lifeline policies designed to help low-income and elderly citizens with the cost of utilities—distort market outcomes. Not only do they create inefficient levels of production and distribution of the service per se, but they can also lead to inflation, inefficient distribution of labor, poor quality in products, shortages, and queuing.

As several of the chapters—especially Hess's on education—indicate, markets often hurt when they work. The adjustments they force in supply and demand risk pricing poorer consumers out of crucial markets (such as those for health care, higher education, and private pensions) and marginal producers out of the market for their product. Railroad marketization, recounts Gaskins, is still haunted by the passionate opposition of Dakota grain shippers, who saw shipping rates rise dramatically as a result of price deregulation and then could no longer keep their prices competitive. Likewise, state attempts to allow competitive rate setting for retail electricity have foundered on opposition from representatives of the poor and the elderly.

On the other hand, macro policies that broadly subsidize those adversely affected by freer market competition—the elderly, the poor, and the isolated—need not distort market outcomes. Such policies address inequalities and income maldistribution apart from the market transactions that produce them. Thus they do not distort the transactions themselves, as do price controls and rate-setting regulations. Policies that perform this function include income transfers that range from Social Security to the Earned Income Tax Credit and Temporary Assistance for Needy Families; the progressive income tax; voucher programs such as food stamps and virtual ones such as Medicare and Medicaid; the direct provision of services (for example, by Veterans Administration hospitals); and subsidized goods and services such as public transportation and the Section 8 housing program. Such welfare state policies soften the market's less desirable impacts.

We draw support for our view of macro policy from Vogel's fine discussion of Japan, but we differ on how to best reconcile micro and macro policy. Vogel favors pro-competitive regulation and planning, strengthened by institutions and institution building. But as he himself recognizes, business can be quite skillful at evading the spirit of such reform efforts, as in the case of Japan. Its firms, he points out, often respond to government efforts to liberalize markets by insulating themselves in some way from the full force of competition. When the government removed capital controls in the 1960s, for instance, corporations increased their cross-shareholdings to protect themselves from foreign takeovers. And when trade was liberalized in the 1970s, some industries replaced tariffs and quotas with private sector substitutes, including preferential procurement practices.

Japan's across-the-board liberalization policies could be compared to the U.S. antitrust policy approach, notorious for its ineffectiveness and deleterious latent consequences. By contrast, we favor policies that foster equity and security at a macro level—such as bank deposit insurance, single-payer health care, child care and transportation subsidies for the poor, and job training—but that do not affect the inner workings of any particular market.

Coping with Cognitive Constraints through Macro Policy

Some regulatory policies may be intrinsically easier to design than others and therefore make fewer demands on the skills and wisdom of regulators. At the same time, some objectives, even if they are not logically inconsistent, may simply be too difficult to reconcile in practice. A key finding of this book is that market design efforts that are limited to constructing a framework for market activity, by establishing property rights and removing regulatory impediments, have proved more successful than those that intervene in specific aspects of market operations or that try to simultaneously establish and constrain markets. This is largely because such frameworks are easier to understand and easier to design. They impose a lighter cognitive burden on their designers and on their implementers.

Market designs range from least to most intrusive and complex. Procompetitive results, on the whole, are most likely to occur where policy does not intrude inordinately and does not pursue a panoply of goals. As Peter Schuck discusses in a concluding chapter, even the most unregulated markets need rules in order to define property rights and proscribe force and fraud. We call this basic form of public intervention "market framing." "Market-perfecting rules"—such as antitrust law, information requirements, and taxes on externalities—may also be needed to remedy any defects that competition cannot cure and may even magnify. Evidence from the cases indicates that designs for competitive markets are most successful when limited to market framing and market perfecting.

Other forms of market design (Schuck describes eight categories) are far more ambitious and intrusive. One form seeks to induce market entry, as in the case of British pension reform. Another simultaneously promotes and constrains competitive behavior through "strings" that ensure the market rewards efficiency yet does not undermine other desirable objectives. School reform proposals, Frederick Hess points out, invariably include provisions designed to prevent competition between schools from placing other crucial values, notably equity, at risk. Such ambitious goals as inducing entry and simultaneously pursuing other objectives, no matter how worthy, turn out to be very difficult to achieve and may well put the entire effort to enhance competition at risk.

Political Sustainability

In most instances of competitive reform, as already mentioned, the prevailing political dynamic favors the status quo. Therefore, as Patashnik argues, market-oriented reforms can only prevail and survive when they reconfigure that political dynamic. Durable reforms do not merely destroy an existing policy subsystem, they generate a self-reinforcing process in which the identities and organizational affiliations of relevant interests change and key social actors adapt to the new regime. Schumpeterian "creative destruction" is central to the creation of politically sustainable circumstances.[6] It does so by eliminating or substantially reducing the power of obstructionist government entities and private firms. In the first case, the destruction is through conscious and targeted reform efforts. In the second, it is the product of the impersonal forces of the market, which have little respect for a corporation's political power or previous large market share and prestige.

Obstructionist government entities take a variety of forms. Some are regulatory agencies, such as the FCC or former Civil Aeronautics Board and ICC. Some subsidize as well as regulate, as in the case of the Department of Agriculture (DOA). Others are direct service providers, like the nation's public school systems. They obstruct competition because it threatens their institutional maintenance and enhancement. To increase their strength, they ally with interest groups that share their anticompetitive objectives; the two, in Patashnik's words, "develop a powerful symbiotic relationship."

Abolishing such government institutions—as was done in airlines and trucking, but not in telecommunications, agriculture, or education—is a vital aspect of market reform because it deprives losers of a useful arena for revisiting their setbacks and creating new forms of regulatory complexity with which to obstruct new competitors. Now that the FAA, ICC, and CAB are extinct, the airline and trucking industries thrive. By contrast, those who would interject greater competition into telecommunications, agriculture, and education continue to be foiled by the FCC, the DOA, and the public school systems, all of which are very much alive and wield more political power and resilience than ever.

From Patashnik's and Levine's investigations, it is clear that pro-competitive airline policy reform was politically strengthened not only by the abolition of the CAB but also by a shift in the interest group dynamics surrounding the airlines. This reconfiguration through the creative destructiveness of a competitive market freed up the air transport market quickly and led to the demise of politically powerful but competitively weak carriers such as Pan Am and Eastern Airlines. At the same time, it facilitated the emergence of new low-cost entrants such as Southwest, Midway, and Jet Blue and persuaded legacy carriers such as United and Delta, along with their unionized workforce, that they were better served by a pro-competitive environment. This new coalition of new and old competitors proved too strong for opponents to the reforms. As Levine concludes, the market forces unleashed by competition destroyed the interest group cohesion created by regulation. As a result of this political transformation, the competitive principle became so deeply engrained that it even stymied later efforts at rent seeking by members of the new coalition. Speaker of the House Dennis Hastert, for one, proved unable to exploit his position to obtain a government-backed loan for the once-powerful legacy carrier United Airlines, headquartered in his district. His appeal was rejected because the administration and most of Washington's political establishment now saw the airlines industry operating in a competitive market system, which they agreed should not be subject to political manipulation.

It should be emphasized, however, that the benefits of abolishing governmental entities do not run counter to those of government-provided risk protection. Rather, they indicate that the government performs a variety of functions and that it does some better than others. It is good at enhancing security, particularly when it does so according to universalistic principles that do not affect competition between firms. It is not so good at regulating individual markets, because its own institutional maintenance needs are likely to cause it to intrude in market operations, to the detriment of competition.

Since political interference is inevitable, it cannot be wished away. If policy planners could frankly acknowledge this political difficulty, they would be less innocent about their function and obliged to plan for political interference well before it takes place. They would see their role in a new light, outside of their comfort zone as calculators of economic efficiency whose purity of heart exempts them from the need to think and act politically. This would force planners to anticipate political problems and cope with them when they are still of manageable proportions. They might anticipate the counterattacks of rent seekers and their bureaucratic and congressional allies by including proposals to abolish intrusive government entities and to alter congressional committee jurisdictions in their initial policy designs.

Policy Implications

The findings of the specific cases in this book and the generalizations we have drawn from them have important policy implications. They give evidence of what markets have done well (fly planes) and what they have not, so far at least, done well (run schools); what markets should do (grow food) and what roles they should divest (compensating "losers"). We also show what government has done well (enabling transport competition) and what it has failed to do well (privatize public pensions); what government should do (provide macro-level risk protection) and what it should not do (intervene in markets at a micro level).

Our findings with regard to risk protection, market design, and political sustainability shed light on three critical policy issues: health care, social security, and food. Health care fits our definition of an appropriate subject for macro policy. It insures individuals against the economic risks of illness. But it is not immune to moral hazard: individuals might well invest more in their well-being and reduce their consumption of health care if they were not insured and therefore had to bear the full cost of their own illnesses and of their medical care choices.

But the public is unwilling to trade the peace of mind that health insurance offers for a diminution of moral hazard. Therefore the relevant policy question is how best to provide such insurance. Currently, in the United States, health insurance for the non-elderly and non-poor is handled more or less as employment security is handled in Japan, by individual firms rather than by the government. And it has the same deleterious economic effects. Firms that are generous in providing health care suffer an economic handicap in comparison with firms that do not or with international competitors whose workers are covered by their governments. Workers, for example, sometimes resist testing the labor market for fear of jeopardizing their health insurance. Thus shifting the burden of providing health care insurance from firms to the government, regardless of the content of that insurance, would improve the competitiveness of American companies and the efficiency of the American labor market.

This example is intended to be merely suggestive. This is hardly the place to try to elaborate a full-fledged health policy framework. Such an effort would begin with the recognition that policymaking for health care is a question of market design as well as of risk protection. And as we suggest throughout this book, its design aspect in particular requires attention to the whole panoply of political and technical design issues involved. Here we limit ourselves to pointing out the business and labor efficiency advantages of a single-payer approach. We are well aware that a full health policy proposal would have to account for the strong interests of doctors, pharmacists, hospitals, insurance companies, and medical schools.

Social Security is the quintessential macro policy, providing all workers with financial protection against the financial risks of old age. But its future must also be considered a market design question, particularly in light of recent proposals for privatization. Like the privatization scheme in Great Britain, they are built on the expectation that new entrants will materialize to offer private plans, even though no one yet knows whether such plans will prove profitable.

As emphasized throughout this and many of our other chapters, this type of cognitive constraint is often exacerbated by a political one. What if the capital markets in which private pension schemes invest suffer a prolonged downturn? The experience in energy markets is instructive. Price increases after privatization made it difficult for energy privatization to survive in Canada or in California. Consumers were simply too resistant to paying more when they had understood the promise of marketization to be that they would pay less. Moreover, for any given consumer, the economic significance of higher energy bills is far less than a loss of a significant part of one's retirement savings resulting from the fact that markets go down as well as up. If workers feel that the viability of their retirement is being threatened, they will demand that the government make up the difference between what they expected to receive and what the private market has delivered.

Faced with these difficulties, policy planners should think like statesmen, not merely technicians, and follow more the dictates of Machiavelli than Adam Smith. They should recognize that incantations about how, in the long run, the capital markets outperform treasury bonds will not placate an insecure citizenry. They should anticipate the political resistance they will face rather than decrying it. Any effort to add a greater private element to Social Security must include credible evidence that everyone will be held harmless by the reform—in short, it must guarantee that they will be at least as well off as if the existing system remained in place. This is an extremely expensive proposition—political resources are as scarce as economic ones. The inglorious defeat of President George W. Bush's Social Security reform effort means that a future president is far less likely to risk political capital on such reform. If providing greater access to the capital markets is indeed a vital way to cope with the realities of an aging population, then his politically shortsighted effort may well prove more costly than a more expensive program guaranteeing pensioners against loss would have been.

In the case of agricultural commodity price deregulation, if farmers are always poised to oppose price deregulation when commodity prices decline, the key to sustainable reform lies in binding the government's hands so as to make price re-regulation almost impossible. This might be done by shifting the farm issue from the domestic to the foreign policy realm, where it is very hard for a government to renege on its treaty obligations. If bound by treaty to allow commodity prices to fluctuate, it would be unable to respond to demands for price supports despite the ability of farmers to mobilize politically. Consequently, perhaps would-be price deregulators should not fritter away their political resources in fighting for a new farm bill unless it is part of a treaty-making process.

Conclusion: The Noninvisible Hand

Our findings have important implications not only for the format and content of public policy but also for the roles and responsibilities of policy planners, entrepreneurs, and analysts. Many cases in this book reveal the deleterious impact of political interference, whether that interference is instigated by producers, consumers, or governmental actors. The greater the access of these groups to key congressional players or to the surviving regulatory agencies, the more likely they are to stymie market competition.

These political realities have great bearing on policy planning, policy leadership, and policy analysis. Above all, political interference is best addressed by political foresight. To reiterate, policy designers must anticipate the likely political objections to proposed policy reform and figure out how best to meet those objections in a manner that is both politically viable and does not unduly interfere with market operations.

Effective public policies are not discovered; they are constructed. Creating competitive markets is a process of market design, not merely deregulation. Markets do not magically spring to life when the government has gotten out of the way, or a thoughtful, well-crafted policy is initially put in place. Furthermore, policies of this kind not only need to be well constructed, but also must be adequately maintained to guard against powerful rent-seeking interests that surround newly established markets. Almost every chapter in this book shows that policymaking pertaining to the design of new markets pits interest group against interest group just as much as old regulatory policymaking did. There are "alligators" on both sides of the river and they never sleep.

In neoclassical economic thought, coordination can occur in the market without a coordinator—under the market's invisible hand. But when markets are created and sustained through policymaking, there needs to be a *political hand* to chart a proper course and steer through the dangerous political shoals.[7] The political mind guiding that hand must be capable of anticipating political obstacles and developing proactive strategies to circumvent and stave off these obstacles.[8] Good policy is better served by the politically savvy opportunistic spirit of a Joseph than by the pessimism of a Jeremiah.

Notes

1. Karl Polanyi, *The Great Transformation* (Boston: Beacon Press, 1944; repr. 1971).

2. Other important ways apart from regulatory redeployment include "soft law," negotiations, and other corporatist approaches adopted by the Bush administration. See chapter 14 by Shapiro.

3. We rely much here on Eugene Bardach's thoughtful description in chapter 15 of the success and failure patterns in these cases.

4. See, for example, Paul Pierson, *Dismantling the Welfare State? Reagan, Thatcher and the Politics of Retrenchment* (Cambridge University Press, 1994); Stephen Leibfried and Paul Pierson, eds., *European Social Policy: Between Fragmentation and Integration* (Brookings, 1995); Peter Hall, *Governing the Economy: The Politics of State Intervention in Britain and France* (Oxford University Press, 1986); Peter H. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford University Press, 2001); Steven Vogel, *Japan Remodeled: How Government and Industry Are Reforming Japanese Capitalism* (Cornell University Press, 2006); Steven Kent Vogel, *Freer Markets, More Rules: Regulatory Reform in Advanced Industrial Countries* (Cornell University Press, 1998); David Vogel, *Trading Up: Consumer and Environmental Regulation in a Global Economy* (Harvard University Press, 1995); David Vogel, *National Styles of Regulation: Environmental Policy in Great Britain and the United States* (Cornell University Press, 1986).

5. Martin A. Levin and Martin Shapiro, *Transatlantic Policymaking in an Age of Austerity: Diversity and Drift* (Georgetown University Press, 2004).

6. Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Row, 1976).

7. For a more detailed discussion of this concept and how policymakers can provide the public sector's missing "political hand," see Martin A. Levin and Barbara Ferman, *The Political Hand: Policy Implementation and Youth Employment Programs* (New York: Pergamon Press, 1985).

8. For an in-depth discussion of how proactive strategic skepticism can help implement a potential AIDS vaccine and treatment program, see Martin A. Levin and Mary Bryna Sanger, *After the Cure: Managing AIDS and Other Public Health Crises* (University of Kansas Press, 2000). Levin and Sanger discuss a strategy for political executives and policy designers of such programs that anticipates the inevitable management conflicts and delays and then takes action in advance to ameliorate and head them off.