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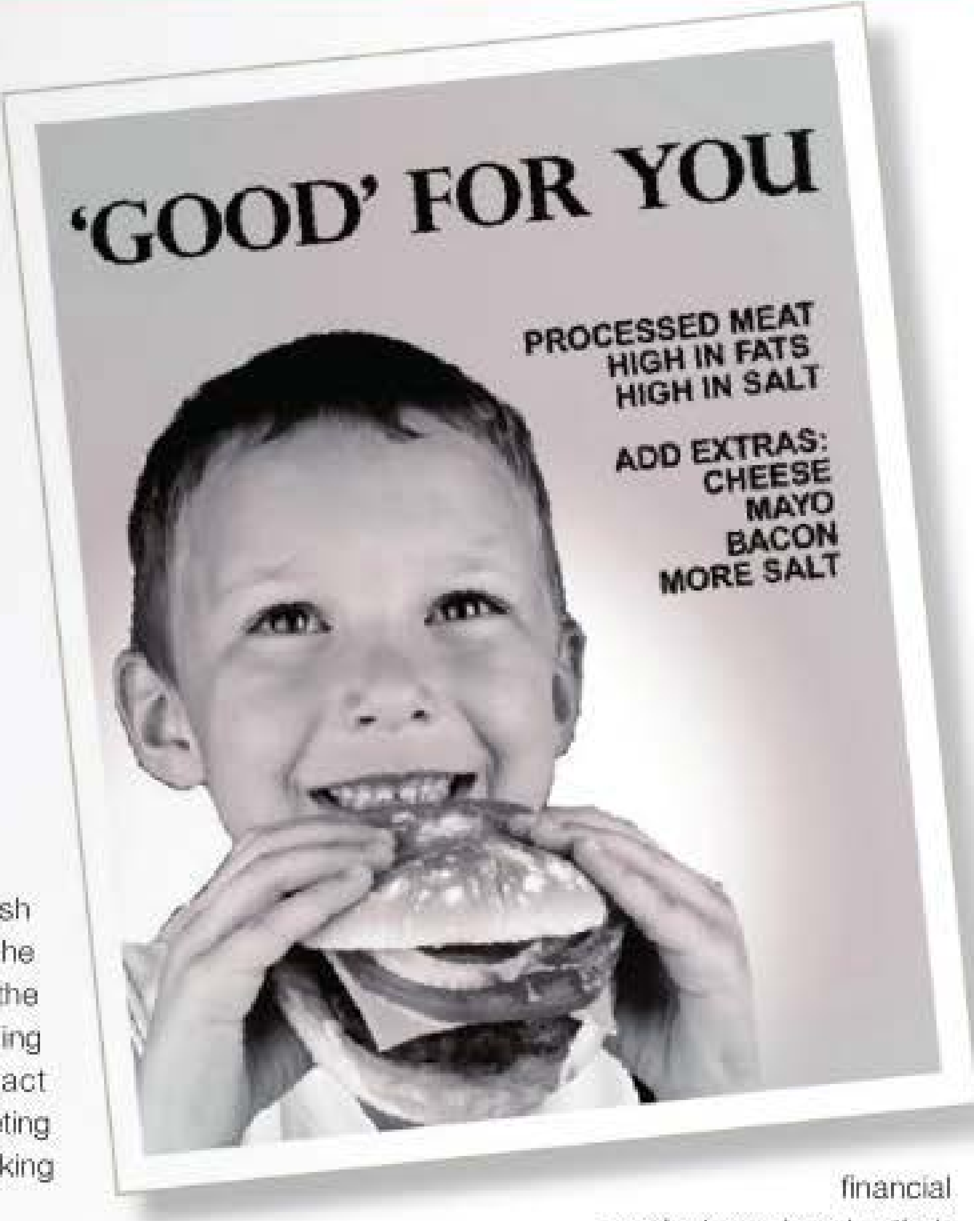
New risks of regulatory capitalism

John Braithwaite discusses the effect of regulatory growth on the development of risks.



The study of both risk and regulation have proved theoretically fertile, and CARR has shown leadership on both fronts. Many risks have been reduced through thoughtful regulation – dramatically reduced in cases such as nuclear safety and the ozone hole. This article focuses, however, on ways risks have changed and grown as a result of the successes of one kind of regulatory growth; in competition enforcement. David Levi-Faur and Jacint Jordana have described a change in the nature of contemporary capitalism to a post-liberalism world of regulatory capitalism, meaning stronger markets but, at the same time, more regulation. Most of the competition authorities in the world were created after 1990; the vigour with which competition has been enforced, and monopoly attacked, has sharpened in developed economies.

Competition drives the more efficient production of 'bads' as well as 'goods'. In the era of regulatory capitalism, many of the bads that are banned have been more effectively regulated. Yet many bads remain legal and pose growing risks. Consider obesity. Competition policy has fostered fat as our fastest growing mortality risk. In food marketing we see competition among progressively more sophisticated marketing pitches that emphasize the sort of person we can be by consuming, as opposed to the quality of the product. A market in the vice of overeating and over-drinking is created by competition in such seduction.

One of Robert MacCoun and Peter Reuter's conclusions from a survey of experiments in drug policy around the world was that legalization of illicit drugs is mostly associated with sharp increases in drug abuse only when it moves on to aggressive commercialization. For centuries, Indians were eating opium without it becoming a drug of mass addiction. It became a Chinese mass addiction when the British East India Company decided to market it there and invest in a more efficient and appealing system for drug delivery than opium eating – opium smoking in a pipe – as well as a network of 'opium dens' to market it. Tobacco had been used ritually by indigenous Americans for centuries, and later Europeans, without causing mass addiction. It was competition between British and American multinationals in the late 19th century that delivered the breakthrough of a more appealing delivery system – the compact cigarette – and more astute marketing conveying the message that smoking was sophisticated and sexy.

This is the supply side of markets in vice. My research on the market for tax avoidance also reveals a demand side. Managers come under competitive pressure when their company is paying a normal amount of tax to apply 'aggressive management techniques' to that liability, and the market rewards managers who do so. Tax is a paradigm case of the new risks of regulatory capitalism. It is not tax non-compliance that allows the super-rich to pay little tax; it is engineering around tax law, which creates new financial products. This has frustrated the political projects of social democrats who believe in redistributing wealth and who also support vigorous competition combined with credible regulation.

The problem of increasingly effective competition encouraging the more efficient production of bads is a general one. For example, the pharamaceutical industry both produces goods that conquer disease and bads that deliver a culture of a little pill for every ill: an epidemic of legal abuse of psychotropic drugs. The more that competitive markets succeed in delivering the more efficient satisfaction of freely chosen preferences, the more efficiently they produce bads as well as goods – however these are defined.

Consider derivatives. Derivatives do good by allowing firms to manage volatility; but they are also used in contemporary capitalism for financial engineering around regulatory risks, allowing managers to shift, rather than manage, risks. During the 2008 financial crisis, US mortgage brokers and banks were not worried about lending to people who were bad risks because they sliced and diced the loans and sold the slices to hundreds of other banks. The new market in financial engineering made it cheaper for US banks to securitize and spread risks than to manage them. There is thus a danger in new financial products engineering their way around old laws to be widely marketed, causing new crises. If a state regulator is smarter than the financial rocket scientists, the market for financial engineering pays her an extraordinarily high price to defect from being a regulator. This happens all the time in the market for tax shelters.

On a more optimistic note, most of Asia grew at a much faster rate during the height of the 2008-9 financial crisis than the NATO states grew before it. There were also NATO states like Canada and Poland whose banks were not afflicted with piles of securitized bits of bad US loans. Poland's banking regulators took the view that they did not understand the risks associated with the derivatives trading American banks were playing at, so they weren't going to allow their banks to play. Such regulators served their nations well. Another reason for Asia's growth is that after the crisis of 1997, its banks focused more on expanding basic strengths than on making their risk management systems as sophisticated as those in the West. When an organization has weak links – persons who pose risks – they can be dealt with by removing those persons, or by using the strengths of those who work around them to expand into the area of responsibility of the weak links. Both strategies were evidenced in Asia.

Now is an era when we need to balance some of the attention we rightly place on the mantra of 'identify risks and control them' and more on 'pick strengths and expand them'. The comparative advantage of the strengths-based approach grows with regulatory capitalism.

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