

Institutional regulation of the economy

The recent financial crisis was a shock for everyone interested in maintaining a healthy and prosperous economy, from labourers fearful of losing their jobs to bankers wanting to maintain power. The global financial system appeared ready to collapse under the strain, and the crisis clearly demonstrated the importance of institutional mechanisms for managing the economy. Most experts agree that the crisis stemmed from a lack of institutional regulation of financial players. Members of the Group of Twenty Finance Ministers and Central Bank Governors (G-20) have demanded a better regulatory system in order to prevent future global financial crises. However, what is a better regulatory system and what lines of research can help to reveal it?

NEED FOR REGULATIONS

Markets are the central institutions of capitalist economies, and regulations are necessary to keep markets operating smoothly^{1,2}. They ensure competition and enhance efficiency. The economy is only a subsystem of society, however, meaning that efficiency cannot be the sole criterion for economic management. A regulation that is effective in stimulating economic efficiency might be in conflict with social norms of justice, solidarity or freedom. There is often disagreement between private and public interests. Societies are deeply divided by the goals and consequences of economic management. Therefore, economic regulations need to be based on more than purely efficiency considerations.

There are different approaches to the investigation of economic regulation. The first is normative, categorizing certain economic goals as desirable, such as ensuring that firms have sufficient capital or reducing risk of systemic failure. The second is



above | At the heart of Wall Street is the New York Stock Exchange, one of the world's largest security exchanges.

empirical-analytical, investigating the historic development of regulatory mechanisms. The third investigates the relationship between institutional regulation and the behaviour of those being regulated.

REGULATORY APPROACHES

An important focus of research into the economy and its management is the relationship between private and public interests, which intersect at a multitude of points. Regulations need to be developed that can effectively balance these often conflicting interests while contributing to economic well-being. For example, a big telecommunications company that is interested mainly in profit might prefer to market Internet connections only in urban areas, but elected officials must ensure that there is Internet access in less-profitable rural areas.

In recent times, banks have been free to take big risks in the pursuit of big profits as long as they have fulfilled certain basic regulatory requirements, such as keeping a minimum level of cash reserves. The financial crisis showed that it is government agencies that ultimately have to take responsibility for the losses when the strategies pursued by the banks fail. Deposit

insurance is de facto provided by the state; therefore, it might be preferable to have the deposit-insurance institution participate in bank decisions, for example by taking a seat on the board, and to emphasize that insurance premiums will rise if certain risky strategies are undertaken.

TAXES AND THE PRIVATE SPHERE

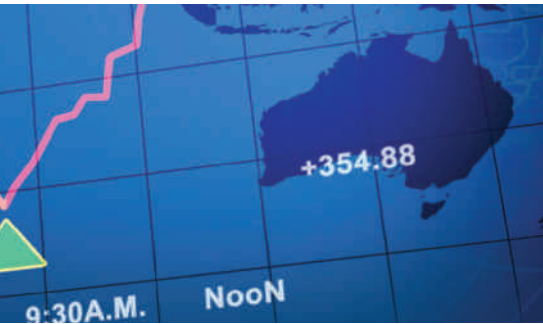
Another important area of research is the tax system, which can be used to help manage the economy. There is a fundamental and insoluble tension between the wish of the tax payer to maximize personal profits and the duty of the treasury to collect the correct taxes based on the economic performance of the tax payer³. This tension is intensified because the treasury knows less about the economic performance than the tax payer, who obviously wants to keep their tax bill as low as possible. From the perspective of the treasury, tax collecting could be made easier by regulations that empower it to dig deeper into the private sphere of the tax payer.

Protection of the private sphere from the state is an issue that is evolving rapidly, given that there is increasingly more information available from, for example, cashless monetary transactions and Internet commerce, and personal data stored on computers. These trends have stimulated political changes: there are new regulations that try to balance protection of the private sphere with the legitimate need of the state for information, as well as regulations that attempt to increase the control of so-called tax havens. The difficulty for the treasury in collecting the information necessary to determine tax bills accurately is compounded when dealing with huge, highly integrated multinational companies.

Finance research can identify such changes and developments, point out related effects, explain and evaluate

Any economy is socially and politically constructed. The way it is socially embedded reflects both prevailing systems of meaning and the results of political 'market struggles' over social regulation.

Investigating institutional regulation of the economy requires studying how economies are constituted as social orders within societies. (Beckert, J. & Streeck, W. MPIfG Working Paper 8/04, 2008).



- Institutional regulations are the key element to steering an economy; such regulations include the legal system, social networks and cultural rules.
- Private and public interests can sometimes take conflicting positions, so must be balanced to ensure efficient and fair allocation of resources.
- Institutional regulations are studied from historical-empirical and normative perspectives, to understand how management of the economy has changed and to provide a basis for policy recommendations.

developments, and provide efficiency-orientated political recommendations. Finance research can also use expanded methodical procedures, such as laboratory or field experiments, to study classic questions concerning finance and give new answers.

HISTORICAL DEVELOPMENT

The historical development of social and political regulations, and their role in economic management, is a further topic of research. It investigates the changes in the political-economic order caused by globalization and liberalization processes. For example, although markets are currently growing past national borders into a world-wide network^{4,5}, regulatory and related social institutions have been slow to follow, offering market players an unprecedented abundance of strategic options. This has made the issue of transnational regulatory institutions, as well as the protection of nationally specific models of capitalism, dominant topics for political actors⁶.

Finally, research on economic regulation also investigates the relationship between the judicial system and the ideal regulatory goals of market players. The main focus of this research is the interplay between societal management mechanisms and individual market players, for example, investigating how the legal system resolves broken contractual agreements between buyers and sellers of goods or services⁷.

Economies are primarily managed through institutional structures. Institutional regulations restrict the options of market players, but at the same time allow for complex economic exchange. Institutions can offer incentives, oversee the efficient distribution of scarce goods and allow normative convictions to become socially relevant. Research in economics, law, economic anthropology, political economy and economic sociology can contribute to the increased political, economic, legal and social knowledge necessary to develop a better economic-regulatory system.



above Traders on the floor of the New York Stock Exchange watch nervously as stocks plunge amid concerns about Europe's debt crisis.

left The financial crisis has had wide-spread effects.

below German chancellor Angela Merkel during a debate in the European Parliament.



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