Widen the market, narrow the competition: the emergence of supranational governance in EU capital markets

Mügge, D.K.

Citation for published version (APA):

General rights
It is not permitted to download or to forward/distribute the text or part of it without the consent of the author(s) and/or copyright holder(s), other than for strictly personal, individual use, unless the work is under an open content license (like Creative Commons).

Disclaimer/Complaints regulations
If you believe that digital publication of certain material infringes any of your rights or (privacy) interests, please let the Library know, stating your reasons. In case of a legitimate complaint, the Library will make the material inaccessible and/or remove it from the website. Please Ask the Library: https://uba.uva.nl/en/contact, or a letter to: Library of the University of Amsterdam, Secretariat, Singel 425, 1012 WP Amsterdam, The Netherlands. You will be contacted as soon as possible.
CHAPTER 2: COMPETITION POLITICS AND SUPRANATIONAL INTEGRATION: A STRUCTURAL APPROACH

At the heart of this thesis stands a question that has been fundamental, if not defining, for political economy as an academic field (cf. Underhill 2000): what is the relationship between the domains nowadays often denoted as ‘the economy’ and ‘politics’? Many scholars have pointed out the tenuousness of this distinction (see Chavagneux 2001), which has itself only taken firm intellectual roots in the 20th century (Mitchell 2002: 80ff, cf. Krätke and Underhill 2006).

Avoiding the artificial economy-politics distinction, the issue is one of the mutual constitution of market structures and patterns of governance (Cerny 1990, Strange 1988, Underhill 2006).

The supranationalization of EU capital market governance lends itself well to the empirical exploration of this issue. Both capital market structures and their governance have changed enormously since the mid-1980s. What is less clear is how these two transformations should be explained if the two domains are conceptualized as intimately connected. The theoretical literatures dealing with regional integration and financial market opening identify a wide range of explanatory factors, but as this chapter shows, on their own terms they remain insufficient to account for the changes that have been observable.

This chapter therefore has two aims. Building on the discussion in the introduction, it first reviews the various strands of theory relevant to the case at hand and exposes their shortcomings. In particular, they fail to incorporate and properly theorize the agency of a small group of well-connected private and public actors as the crucial link between changing market structures and transformations in governance patterns. This link, so goes the argument here, lies in the political and economic stakes these actors have in the way political institutions and regulatory regimes structure inter-firm competition and thereby market access between countries and different market sectors. Regulatory and institutional preferences, in turn, are themselves inspired by the market environment that actors confront, generating what has been called
'structuration' (e.g. Giddens 1984, Wendt 1987). Over time, this thesis argues, changes in either market structures or patterns of governance can only be understood with an eye to this larger whole.

The second part of this chapter builds an analytical approach suitable to explaining the supranationalization of capital market governance based on these central insights—an approach that will be called ‘competition politics’ for short. While scholars of International Political Economy (Cerny 2000, Hobson and Ramesh 2002, Underhill 2006) and European integration (Christiansen and Jørgensen 1999, Niemann 2006) have repeatedly called for an appreciation of the structuration concept, its empirical application to date has been rare. The approach developed in this chapter helps bridge that gap.

**European integration**

With the emergence of supranational governance in EU capital markets as the empirical anchor of this thesis, theories of European integration are the natural place to begin an exploration of scholarly approaches. Ever since Haas’ seminal monograph on *The Uniting of Europe* (1958), states’ willingness to integrate policy-making and potentially transfer authority to the supranational level has been a subject of academic debate (early on Lindberg 1963, Hoffmann 1966, Schmitter 1969, 1970, for overviews, see e.g. Rossamond 2000, Wiener and Diez 2004).

One popular explanation was formulated as liberal intergovernmentalism (Moravcsik 1991, 1993, 1998). Regional integration, this approach argued, was in essence comparable to the building of international regimes traditionally studied in International Relations (Krasner 1983, Haggard and Simmons 1987, Hasenclever et al. 1997). In a nutshell, regional integration served national interests. Moravcsik’s own contribution to this strand of thinking was a heavy emphasis on the domestic sources of governments’ preferences (Moravcsik 1997, cf. Weiss 2003), which together with international institutions’ potential for providing collective goods explained observable patterns of governance (cf. Keohane 1988, Scharpf 1997a).
In principle, two kinds of criticisms have been levelled against liberal intergovernmentalism—that it misrepresents the functioning of existing supranational institutions and that it misunderstands the process that led to their emergence in the first place (on the distinction, cf. Jachtenfuchs 2001). Many scholars of multi-level governance (MLG) have argued that regional integration has compromised the sovereignty of EU member states more than is compatible with Moravcsik’s depiction of European politics as a purely intergovernmental affair (Marks et al. 1996, Risse-Kappen 1996, Kohler-Koch and Eising 1999, Hooghe and Marks 2001, Peters and Pierre 2001). The degree to which supranational bodies such as the European Court of Justice or the European Commission have escaped direct government control makes it implausible to think of the former purely as agents of member states, who act as principals (cf. Pollack 1997). In addition, informal political institutions have also grown beyond the nation state as supranational bodies were developed (e.g. Cowles et al. 2001). In short, the world of ‘two-level games’ (Putnam 1988) to which liberal intergovernmentalism is indebted is an inappropriate representation of both formal and informal flows of political authority in the European Union.

The second charge against liberal intergovernmentalism is that it has little to say about regional integration as a systematic process. It has failed to theorize the conditions under which past regime formation could feed back into ‘domestic interests’—either through the redefinition of individual actors’ interests or their identities—and thus unleash a dynamic of its own. The early neofunctionalist integration theorists had tried to do just that but in the eyes of Ernst Haas, widely credited as the founding father of the scholarly field, had remained unsuccessful. As Western European governments failed to cooperate in the face of the economic crisis of the 1970s, he declared regional integration theory obsolescent.

With the re-launch of European integration since the mid-1980s (Tsoukalas 1997, Dinan 1999), theorizing building on neofunctionalism has enjoyed a revival (Sandholtz and Stone Sweet 1998, Niemann 2006). Also Haas himself revised his earlier, negative judgement in the preface to the 2004 edition of The Uniting of Europe. Neofunctionalism has often been misunderstood and
caricatured, however, thanks to functionalism’s common association with an apolitical
automatism in the evolution of political institutions, which clashes with more political readings of
EU history (e.g. van Apeldoorn 2002). But this is not what neofunctionalists claimed or claim. It
is therefore worthwhile revisiting some if its central tenets.

Schmitter’s (2005) summaries of Haas’ original propositions largely overlap with his own
theory of regional integration (Schmitter 1970). Those most relevant for this thesis are
recapitulated below; they are complemented by related, often more recent, insights from EU
integration and governance studies.

- “States are not the exclusive and may no longer be the predominant actors in the
  regional/international system.” (Schmitter 2005: 259, emphasis in original) The façade of
  states—understood here as national state governments—as the most visible actors may
  only mask a temporary equilibrium of different social groups, for example classes. In
  addition, non-state actors can oppose or promote integration independently of
government action.

In his original formulation of integration theory, Schmitter pointed out that change in the
constellation of actors over time can itself be the result of previous integration:

The most important transformation in the structure of the model during
these stages occurs in the nature of national actors. Up to this point they
have been treated as units with a single integrative or disintegrative
strategy during any crisis. Now they begin to appear as differentiated actors,
as a plurality of negotiating units (classes, status groups, sub-regions,
diântelas, bureaucratic agencies, ideological clusters, etc.). [...] These
“subnational” fragmented actors [...] will begin to form stable
“transnational coalitions” of support and opposition to particular
measures. The policy vector now becomes the product of alliances that
cut across national boundaries [...]. National governmental actors may
continue to play the preponderant role in the concatenation of strategies,
but they can be circumscribed, if not circumvented, by coalitions of
other governmental actors with subnational groups and regional técnicos.
(Schmitter 1970: 864f, emphasis in original)
It is widely acknowledged that the most important non-state actors directly participating in EU policy-making are firms and business associations (Feld 1970, Cowles 1995, van Apeldoorn 2002). Over the past decade, business lobbying in Brussels has grown exponentially (van Schendelen 2002, Greenwood 2003, cf. Coen 2007) while business actors increasingly organize transnationally (Coen 1998, for financial services, see e.g. Grossman 2004).

In addition to the changed preferences of many business actors, this fragmented view of the state mirrors how the EU-component of policy-making has grown over the past two decades in a range of fields (Kohler-Koch and Eising 1999, Hooghe and Marks 2001) and how supranational actors have created opportunities for the direct participation of societal actors—what Schmidt (2004) has called ‘government with the people’—through consultation procedures, expert committees, etc. For the purpose of analysis, then, there is no reason ex ante to focus exclusively on (unified) public actors, neither on the national nor on the supranational level.

- “Decisions about integration are normally taken with very imperfect knowledge of their consequences and frequently under the pressure of deadlines or impending crises.” (Schmitter 2005: 259, emphasis in original) Actors therefore frequently miscalculate the results of their own political efforts. "Knowledge"—both as a product of political processes and a resource to influence them—has attracted increased attention within EU integration studies since the second half of the 1990s (Risse 2004). Fusing the ideas that genuine deliberation at the EU-level is both more democratic and produces better policy than hard-nosed strategic bargaining, scholars have searched for the conditions under which such deliberation can emerge (Joerges and Neyer 1997, Neyer 2003, cf. Schmalz-Bruns 1999). For example, Niemann (2004) has argued that high issue complexity, the shared ‘life world’ of a policy community’s members and a low degree of politicization all promote communicative action (cf. Risse 2000). The composition of the policy community itself can of course be highly political by excluding important stakeholders; communication between insiders may actually reflect the institutionalized limits of their discussion. Consensus reached
through communicative action may still be the result of an unrecognized intellectual hegemony (Hay and Rosamond 2002, McNamara 2002), while the complexity of an issue area such as banking may force policymakers to rely on experts (McKenzie and Khalidi 1996) and potentially expose them to self-interested manipulation. Regardless of just how strong these ‘knowledge’-effects are in practice, they call for close empirical attention to the process of rule making and supranational integration, rather than just an imputation of ‘rational’ interests into actors.

- “Since actors in the integration process cannot be confined to [actors at the national level], a theory of it should also explicitly include a role for supranational persons, secretariats and associations.” (Schmitter 2005: 260, emphasis in original)

Departing from the realist/liberal intergovernmentalist proposition that member states are in control of EU integration (Moravcsik 1993, 1998), scholars have explored ways in which supranational EU bodies—especially the Commission—may themselves have an influence on the integration process and why member states would allow such an erosion of their sovereignty (e.g. Marks et al. 1996, Pollack 1997, Hooghe and Marks 2001). One branch of this debate has mirrored discussions among institutionalist scholars more generally (Hall and Taylor 1996) and questioned what sort of control ‘principals’ still have over the institutions they have created (cf. Jupille and Caporaso 1999, Pollack 2004). Where rational institutionalists argued that by and large, institutions can still be understood as ‘instruments’ of those who have established them (Scharpf 1997a, 2001), historical institutionalists have pointed to ways in which they eventually outgrow the intentions of the creators (Pierson 2000a, 2000b, cf. Jervis 1997).

By now, it is hardly disputed that both the ECJ and the Commission enjoy room for manoeuvre (Pierson 1996, Pollack 1998). In a review of Nordlinger’s On the Autonomy of the Democratic State (1981), Krasner lists the ways in which state actors—they are equally applicable to supranational actors such as the Commission—can exercise independent influence on policy:

[they] may initiate policy and provide access for particular societal groups [and] reinforce a weak level of convergence [of social preferences] by manipulating information, inflating the success of ongoing programs,
setting agendas, appealing to widely shared symbols, playing upon
derere to official expertise, and deflecting potential opposition.
(Krasner 1984: 231)

What is less clear is how supranational actors’ room for manoeuvre relates to other
factors. Gottwald (2005) for example argues that the supranationalization of capital market
governance is largely attributable to the agency of the Commission. However, he does not specify
how the visible actions of the Commission relate to the much less visible economic and political
environment in which it operates. Similarly, Posner (2005) has shown how the Commission was
crucial to setting up EASDAQ, the European version of the American NASDAQ stock market.
But again, it remains unclear how much this (eventually unsuccessful) initiative relied on
contingent environmental factors. In our case, two initiatives to integrate European markets for
investment services produced strikingly different results while the Commission was supportive of
integration both times. An explanation for integration will therefore have to be sought elsewhere;
the Commission is by definition involved in every successful EU legislative project.

oc “Interests, rather than common ideals or identity, are the driving force behind the
integration process [...].” (Schmitter 2005: 259, emphasis in original) The interests of
actors can change in the course of the integration process, often in light of the
(potentially unequal) distribution of its benefits.

The idea that actors’ pro-integration inclinations can be both the source and the result of actual
integration is central to neofunctionalism as a theory. To see interests as the driving force behind
integration is not particularly controversial (see, however, Neyer 2003; Niemann 2006: 24),
especially if interests are not seen as objectively given and integration is understood as a mix of
creating joint gains (‘problem-solving’ in Scharpf’s language) and conflicts over the distribution of
however, is whose interests actually count in the supranationalization of governance.

Critical approaches to EU integration, for example, see conflicting class interests at the
heart of European integration (e.g. van Apeldoorn 2002, Bieling 2003, Cafruny and Ryner 2007).

48
Supranational governance here is a result of and mechanism for the transnational integration of capitalist relations of production. By emphasizing the functionality of supranational governance for a particular set of societal interests, the analysis dovetails with neofunctionalism. At the same time, the approach leaves little room for the independent effects of either political or economic institutions, and it therefore offers insufficient theoretical guidance to the actual political process by which collective actors translate their economic interests into institutional change.

Supranationalists also see the interests of particular social groups behind integration. Stone Sweet and Sandholtz for example argue that:

supranational governance serves the interests of (i) those individuals, groups, and firms who transact across borders, and (ii) those who are advantaged by European rules, and disadvantaged by national rules, in specific policy domains. (Stone Sweet and Sandholtz 1998: 4)

In contrast to critical theorists, they are relatively agnostic about the potential societal alliances that may promote or oppose integration:

Some elite groups (leadership of political parties, industry associations, and labour federations) begin to recognize that problems of substantial interest cannot be solved at the national level. These groups push for the transfer of policy competence to a supranational body, finding each other and establishing cross-national coalitions along the way. If the problem is important enough and pro-integration elites are able to mount sufficient political leverage, governments establish supranational institutions. (Stone Sweet and Sandholtz 1998: 5)

While this argument is plausible, it cannot in itself account for two crucial ingredients of the dynamic it describes: just what are the ‘problems of substantial interest’ that motivate these elite groups to push for supranational integration? And equally important, why can some groups ‘mount sufficient political leverage’ to implement their vision on supranational integration while others cannot? Even though neofunctionalism and its theoretical offspring posit a general positive relationship between supranational integration and the cross-border integration of social and economic space, they underspecify the concrete actors and processes that act as ‘transmission belts’ between the two. Sandholtz (1993) himself has pointed out that different
theories were needed to explain and connect integration dynamics and domestic preference formation, so this lacuna is not a material defect of neofunctionalism and related theories. It does, however, necessitate an exploration of the political economy dynamics in the policy field in question to fully understand the emergence and functioning of supranational governance.

Financial market liberalization and regulation

The supranationalization of EU capital market governance has had the cross-border integration of financial markets as its professed goal. Such market-opening has not been limited to the European Union, however, and given the global trend towards financial liberalization (J. Williamson and Mahar 1998), many scholars have first looked to the international level for the driving forces behind it. In particular, they have drawn inspiration from debates in International Political Economy that have identified capital mobility as the driving force behind ‘globalization’ and domestic change in general (affirmatively Gill and Law 1989, Andrews 1994, Pauly 1995, Keohane and Milner 1996, Garrett 1998, sceptically Swank 2002, Mosley 2003, for an overview see Berger 2000).

Laurence (2001) has combined this insight with the notion of regulatory competition (Esty and Geradin 2001, McCahery and Geradin 2004 for a critical assessment), which builds on Tiebout’s original contribution about patterns of local taxation and expenditures. Tiebout (1956) argued that if citizens were free to settle in any of a number of municipalities, they would choose the one offering the ‘optimal’ mix of costs (taxes) and benefits (desirable municipal expenditures). To attract mobile citizens from elsewhere or prevent emigration, municipalities would adapt their taxation and expenditure regime to match citizens’ preferences (cf. D. Vogel 1995, Lazer 2001).

Laurence has interpreted recent waves of financial market liberalization in this vein (2001). In his eyes, inter-jurisdictional capital mobility has allowed investors to break the previous, often cartel-like grip of local financial services producers on national markets and regulatory regimes. In the face of capital mobility, governments opened national markets and invited foreign competition, much to the chagrin of domestic financial firms, whom Laurence has
seen as the primary losers of financial liberalization.

The empirical record is not easily squared with this argument. Studies of regulatory competition in financial services generate mixed evidence, at best (Hertig 2001, Jackson and Pan 2001, Trachtman 2001). Major variations in the timing of liberalization remain unexplained. And most importantly, rather than being losers of financial integration, large investment banks have continued to post record profits as markets were opened up (cf. Augar 2005).

The core failure of Laurence’s argument lies in its disregard for the actual policy process that is supposed to translate abstract macro-forces (capital mobility) into policy change. Of the four ‘pathways of influence’ of internationalisation on domestic politics he suggests, one stands central: the ‘threat of exit’ of mobile asset holders. Yet it remains unclear how these threats matter to policy makers, especially given these asset holders’ lack of embeddedness in the actual policy process. The most concrete suggestion Laurence makes is that domestic banks, who are well established in national policy communities and allegedly worry about their business, ‘lobby policy makers on behalf of mobile-asset consumers whose business the service providers want to keep or win’ (Laurence 2001: 193). Here, the argument falters: if indeed large banks have been beneficiaries of market opening, as empirical evidence strongly suggests, it becomes much more plausible that their lobbying has been self-interested rather than cow-towing to mobile investors. The regulatory competition dynamic that forces change on unwilling banks and governments becomes unconvincing as the source of market-opening.

Indeed, it is misleading to construe capital mobility as an exogenous force to begin with. Helleiner has shown (1994) how central financial market developments over the recent decades have been the result of conscious public policy, rather than being induced by outside forces. Rather than being able to explain financial market opening with capital mobility, the question puzzle lies in the political choice of governments to introduce capital mobility in the first place.

In addition, models of regulatory competition generally ignore the fact that governments not only compete with each other but can also cooperate (Mc Cahery and Geradin 2004). To the
extent that regulatory competition is seen as undesirable, governments can establish regimes to
uphold higher standards (Krasner 1983, Hasenclüber et al. 1997). And indeed, states have
cooperated to agree on common rules in a number of financial domains (Porter 1993, Underhill
1993, Porter 2005: 31ff). Regardless of whether such regimes spring more from a desire to
produce collective goods cooperatively or from distributive struggles (Kapstein 1992, Nabors and
Oatley 1998, Singer 2004), market opening can be the result of multilateral bargaining as much as
of unilateral adaptation (Simmons 2001).

In the case of EU member states, governments have chosen a mix of both strategies.
Most market opening in the 1980s was unilateral (see Cerny 1989 for France, Moran 1991 for the
UK, Story 1997, Lütz 2000 for Germany). Agreeing EU-wide rules, in contrast, is by definition a
multilateral affair. Here liberalization is an instance of negotiated market opening—something
that most comparative studies (prominently S. Vogel 1996) cannot accommodate because they
model liberalization as a domestic political adaptation to changes in the global environment (cf.
Keohane and Milner 1996). Regardless of whether market opening is a unilateral or multi-lateral
affair, these shortcomings call for a much more in-depth appraisal of the actual policy processes
and concrete actors who lobby, draft policy proposals and bargain to effect it.

This also applies to the second popular ‘top-down’ explanation of financial market
change, technological progress (overviews of such arguments can be found in Cybo-Ottone et al.
2000, R. Lee 2002). This line of argument is particularly common in the business literature (e.g.
Holland et al. 1998, I. Walter and Smith 2000, R. Smith and Walter 2003). The general idea is that
technology undermines the boundaries between national financial markets and at the same time
generates economies of scale that increase the welfare gains associated with market integration.

There can be no doubt that technological innovation has changed the face of financial
markets. But arguments that attribute causal power to it have clear weaknesses (Sobel 1999: 8ff).
Technology is an instrument that purposeful actors use to attain their own ends (e.g. Henwood
1997: 137ff, Partnoy 2002), even if success is never assured (Goldstein 1995). In this sense, it is
no more than a means towards an end that emerges from a dynamic distinct from technological progress—be it the struggle between capital and labour, between different firms, between firms and governments, or between debtors and creditors.

Technological progress by itself cannot explain why existing innovations are applied in some cases and not in others. For example, why do institutional investors still have to pay intermediaries to trade shares for them when they could as well communicate directly with exchanges (Mahoney 2002)? And what has motivated governments to obstruct the use of technology, for example the setting up of remote trading screens (Mügge 2006)? In short, technology is an insufficient explanation for financial change without an account of the motivations of those who regulate its application and, indeed, financial markets as a whole.

Normative theories of financial regulation draw on neo-classical economic thinking to explain the necessity of such regulation as well as the desirability of clear limits to state intervention in ‘markets’. In this view, market failures stemming from systemic risk, ‘moral hazard’ and ‘adverse selection’ (Akerlof 1970) serve as the central justification for otherwise illegitimate state interference in the marketplace (Herring and Litan 1995, Goodhart et al. 1998). Governments provide collective goods: they increase the safety of the financial system as a whole, increase the allocative efficiency of financial markets through the alleviation of information asymmetries, and thereby boost overall welfare (Gertler 1988).

Yet such a normative view again leaves regulation underdetermined (Laurence 2001: 30ff). For example, governments can design stringent rules to prevent individual bank failures—an approach likely to entail limits to competition, driving up costs for consumers. Alternatively, governments can provide a general ‘insurance’ for institutions that fail, and leave them exposed to more competition, which is likely to lower costs but also increases the chance of future failure. Normative theories fail to explain why one would be preferred over the other.

Stigler’s theory of ‘regulatory capture’ addresses this gap, arguing that regulation regularly falls prey to self-interested manipulation by regulators and the regulated (Stigler 1971). Regulation
not only provides collective goods, but entails costs and benefits that are distributed unevenly throughout society. Independent of its alleged goals, regulation is contested between social groups aiming to secure benefits for themselves and shift costs onto others:

[The] problem of regulation is the problem of discovering when and why an industry (or other group of like-minded people) is able to use the state for its purposes, or is singled out by the state to be used for alien purposes. (Stigler 1971: 4)

Stigler envisioned four kinds of ‘favours’ that industries desire from governments: money (through direct or indirect subsidies), controls on market entry, limits on the availability of substitutes for their own products combined with an encouragement of the consumption of complements, and price controls. Over time, he argued, government officials were likely to build their own ‘constituencies’ with whom they entertain reciprocally beneficial relationships. Stigler’s vision on what policy makers received in return for granting privileged access to policy-making remained narrow, however:

The industry which seeks regulation must be prepared to pay with the two things a [political] party needs: votes and resources. (Stigler 1971: 12)

Conceiving ‘politics’ in terms of elections led Stigler to conclude that in the struggle over the costs of regulation, producers would regularly win out over consumers. Producers are relatively small in number but have high individual stakes in ‘their’ field of regulation. Individually, they are willing to invest significantly in tilting policy in their favour, he argued. The costs of competition-restricting regulation, in contrast, are spread over a large group of consumers, whose individual burden from a specific measure is relatively small. Individual producers thus have a higher incentive to lobby regulators than do individual consumers. Second, also owing to the difference in numbers, producers find it easier than consumers to organize and mobilize collectively (cf. Olson 1965). Third, in industries with significant employment, producers might be able to mobilize the votes of their employees based on the extension of political favours. These three factors taken together, Stigler argued, would systematically advantage producers and tilt
regulation in their favour.

Stigler’s image of regulatory capture had a number of shortcomings, though. First, even though it is plausible that consumers are generally losers from regulatory capture, it is not clear that domestic producers are the only societal actors vying for influence of regulatory policy or, for that matter, that they do so in a united front. Producers are after all rivals of each other. Sobel (1994) has used an approach that focuses on competition between providers of financial services to explain reform trajectories in British, Japanese and US capital markets in the 1970s and 80s. He concluded that market liberalization resulted from domestic struggles over market domination; international pressure was secondary. In all three cases commercial banks had been excluded from the lucrative capital market business. When for idiosyncratic and exogenous reasons they faced problems of profitability related to market saturation, they challenged the market position of the securities houses and brokers—the market incumbents—by lobbying for market opening. In all three cases, commercial banks were successful. Kroszner and Strahan (1999, 2000) have found similar dynamics behind the abolition of inter-state branching restrictions in the US.

Sobel’s perspective shares a second shortcoming of Stigler’s approach, however. Neither can easily account for the opening of national markets to foreign competitors. In both cases it is argued that national policy insiders dominate regulatory policy making. If that is true, why would they allow foreign firms in? Finally, Stigler operated with a highly simplified model of politics, one that saw public and private actors connected by money, votes and regulatory favours. That, however, grossly misrepresents the way regulatory policy functions in practice. A thorough understanding of regulatory politics has therefore much to learn from scholarship that has put policy processes and the actual functioning of the state under the analytical magnifying glass.

Private and public actors in regulatory policy

In the pluralist view that underlies Stigler’s model,
The government is seen as a cash register that totals up and then averages the preferences and political power of societal actors. (Krasner 1984: 227)

As Krasner himself points out, this is an inadequate description of the American state, let alone of more corporatist ones, for at least two reasons: political institutions have independent effects and the state can be a powerful actor in its own right.

What has come to be known as historical institutionalism has pointed out that political institutions are neither reducible to societal forces at any given moment—as functionalist, rational-choice institutionalism had suggested—nor, for that matter, to the intentions of their originators (Skocpol 1985, Pierson 2000b). Institutions are hard to change ('sticky' in the jargon), and by benefiting some societal groups more than others, create their own constituencies which invest in their reproduction (Pierson 2000a). Path dependency is the result.

As Hall and Taylor (1996) point out, both sides of this debate have a point: on the one hand, actors when they establish institutions are likely to have clear intentions. And though path dependencies can clearly be identified in political-economic research, paths shift and can be broken, often for reasons that remain poorly integrated into historical institutionalist models (Deeg 2001, Crouch and Farrell 2004). On the other hand, whether these institutions then deliver the results the actors hoped for depends on factors that must be established empirically.

Political institutions above all matter for regulatory politics because they structure societal groups' access to policy-making (Pierre and Peters 2002). Empirically, policy communities that cover specific issue areas are relatively circumscribed, while their institutions function to keep outsiders out. Political institutions thus give members of policy communities what Barnett and Duvall (2005) call 'institutional power'—power that can be used for a broad variety of ends not necessarily related to the reasons for the existence of the institution.

Banks' institutional power has mainly derived from the varying roles they have played in national economies (e.g. Zysman 1983, Crouch and Streek 1997, Allen and Gale 2000). For example, Germany's coordinated market economy was linked to a corporatist political system
that enabled the positive coordination of economic policies (Schmitter 1979, Jayasuriya 2001). France’s state-led economy was mirrored in highly centralized structures with the state, and in the case of financial markets the Trésor, at their apex (Loriaux 1991, Schmidt 1996, Lalone 2005). Finally, lack of coordination between economic policy fields in Britain after the Thatcher revolution translated into weak political institutions to connect the government with economic associations, be they trade unions or business groups. These patterns, originally embedded in national varieties of capitalism, also emerge in the governance of securities markets (Coleman 1996).

In his analysis of financial market regulation, Vogel (1996) has identified national varieties of capitalism as central factors in the different trajectories financial liberalization took, including in the three countries most relevant to this thesis: the UK, Germany and France. He concludes that all three faced similar external pressures for adaptation but their responses were path dependent: the UK—already a liberal economy—further opened its markets whereas Germany and France ‘strategically reinforced’ their governments’ steering roles in theirs. However, Vogel does not clarify whether path dependency is best understood as an adaptation of dysfunctional economic institutions or the result of an institutional legacy that empowers specific actors.

The former view draws on institutional complementarities in national ‘varieties of capitalism’ (Hall and Soskice 2001b). Due to the co-evolution of economic institutions, so the argument, financial markets have come to ‘fit’ their economic environments. These institutional complementarities have often generated positive externalities and have thus increased overall welfare. State actors with a stake in overall economic performance should favour reproducing advantageous national regulatory regimes or adapting them to those changes in the global environment that compromise their optimality (on such ‘adaptive pressures’, see e.g. Schmidt 2002, Glyn 2006, for a critical view see Hay and Rosamond 2002).

Yet comparative political economists still debate whether this is a valid depiction of national varieties of capitalism and the factors that are decisive for their convergence or

As is the case within other institutions, the role of knowledge in policy-making is a double-edged sword. It has independent effects, for example by structuring access and pre-selecting policy solutions (P. Haas 1992, Hall 1993, Zito 2001). In highly complex policy fields, actors with expertise and a clear sense of their own interests are likely to be at an advantage over less well-informed actors with only vague preferences. On the other hand, actors can purposefully generate and manipulate knowledge for their own ends. How the ‘independent’ effects of knowledge compare to its instrumentalization by purposeful actors can thus differ from case to case and is therefore again a question for empirical research.

Comparative studies of financial market policy-making (e.g. Moran 1991, Coleman 1996, Josselin 1997, Lütz 2002) show that central banks, finance ministries, regulatory agencies and the regulated themselves often form the inner circle of policy communities. The policy communities matter to political outcomes because they

limit participation in the policy process, [...] define the roles of actors, [...] define which issues will be included and excluded from the policy agenda, [through] the rules of the game [...] shape the behaviour of actors, [...] privilege certain interests, not only by according them access but also by favouring their preferred policy outcomes [and] substitute private government for public accountability. (Rhodes 1997: 10)

In contrast, the wider public, other stakeholders and national parliaments are normally at the fringes of policy-making. These studies also shatter the idea that regulation is a tug-of-war between the regulators and the regulated (cf. Clarke 2000). Historically, what is nowadays considered regulation has been mostly effected by guilds (for an overview cf. Braithwaite and Drabos 2000). Also today, rather than opposing each other, private and public actors form ‘advocacy coalitions’ (Sabatier 1988, 1999) that jointly pursue shared policy objectives. Given the
conceptual and historical blurring of the public-private divide, ‘[in] this world the language of regulatory capture is largely devoid of meaning’ (Hancher and Moran 1989: 276)—regardless of Stigler’s valuable insights about the impact of particularistic interests on regulation.

If regulation is to be located, then, we may say that it exists on a political space between law and society, a space inhabited by the state, private interest groups and regulatory agencies, some public, some private, some mixed. (Clarke 2000: 21)

If this blurring of the line between the public and the private is taken seriously, then certainly in a historical view, theories of institutional change or market opening that are based on a stark public-private distinction clearly fall short. Private and public actors form coalitions both to shape markets in their own interest and to craft political institutions that help them attain their goals and solidify their grip on public policy. In the long-term process of this mutual constitution, little remains fixed: the responsibilities of ‘public’ and ‘private’ actors in policy-making change, as do the levels of aggregation at which they come together. It is in this sense that the state—the crystallization of the political economy struggles unfolding in society—can be understood as ‘the problem of international political economy’ (Underhill 2006: 16, emphasis in original, cf. Cerny 1990).

The competition politics approach

Most of the theories discussed so far have described different parts of the political economy elephant that they study well, to borrow Puchala’s (1972) phrase. But they have insufficiently appreciated the mutual constitution of patterns of governance, market structures and market rules with purposeful actors as the nexus between them (see figure 1). The final part of this chapter proposes a framework to financial market governance that aims to address that shortcoming. It not only suggests that the different theories discussed all deserve to be appreciated, and that the processes they describe simultaneously contribute to real world political economy outcomes. It argues that they can be synthesized to describe one integrated, larger dynamic—competition politics.
Figure 1: Actors and the political economy environment they confront and shape

Regulation, political institutions and firm preferences

Regulation structures the behaviour of economic agents and thereby markets. Indeed, market sectors dealing in intangibles such as investment services are effectively ‘regulation-defined’ (Vetor 1987). But what ends does regulation serve? In the passage that prefaces this thesis, Adam Smith already argued that producers in particular sectors oppose efficiency-enhancing competition when he wrote:

[the] interest of the dealers [...] in any particular branch of trade of manufactures, is always in some respects different from, and even opposite to, that of the public. To widen the market and narrow the competition, is always in the interest of the dealers [...]. The proposal of any new law or regulation of commerce which comes from this order, ought always to be listened to with greatest precaution. (A. Smith 1937 [1776]: 250)

But how important are these producer interests for financial market regulation? As a number of studies of domestic regulatory reform have found, they can be considerable (Sobel 1994, Kroszner and Strahan 1999, 2000, Vitols 2004, for an overview, see Hardy 2006). To sustain
prices for their products and thus their profits, producers use regulation, not so much against consumers, but against each other. Fligstein has argued that in an economic-sociological perspective, the primary function of regulation is to prevent ruinous competition (Fligstein and Mara-Drita 1996, Fligstein 2001). From the perspective of firms, keeping competitors out and thereby securing rents and organizational survival are core aspects of regulatory regimes (for a similar argument from a firm-perspective, see Shaffer 1995).

For market incumbents and their (potential) challengers, then, the central quality of regulation is that it sets the terms of competition (Underhill 2003: 765f, see also Underhill 1998): it determines who is allowed to compete in which market segment under which conditions. In wholesale financial markets, regulation plays a much larger role in reproducing prevailing market structures than in other sectors where factors such as ownership of scarce resources, inherited product differentiations (potentially bolstered by patents), and hard-to-change customer relationships form larger impediments to change. Regulation forms one of the main obstacles for large players that command both the necessary financial resources and reputation to establish themselves in new markets or segments. To use Stigler’s language, ‘capturing’ financial market regulators—or preventing their capture by others—becomes an integral part of companies’ business strategies. Struggles over regulation are struggles over market shapes—the way different segments and fields of economic activity are delineated.

This does not mean that banks’ strategies derive neatly from their environments. Studies of their strategy-formulation have shown that no single theory can capture the different environmental, institutional and firm-level factors that play a role (Milbourn et al. 1999, Flier 2003). As political strategies normally derive from business objectives, both firms’ policy preferences and the vigour with which they pursue them do not always reflect their ‘objective’ situation in the market place. Disruptive events are often necessary to break organizational and cognitive inertia. It is therefore difficult to predict when environmental change will translate into a review of strategy. But as Flier’s study (2003) shows, once the review takes place, environmental
and institutional factors play an important role in determining the direction of change (cf. Hillman and Hitt 1999).

**The institutional power of financial firms**

Over time, the population of firms adapts to their market environment; those firms that come to dominate a market segment owing to the rules that govern it will become the natural constituency in favour of its reproduction (cf. Fligstein 2001). But how are these preferences inserted into the actual policy process? In the case of banks, their central role in national economies will generate privileged access to public actors. Financial firms jointly create regulation with regulators, they cooperate with governments in selling the latter’s debt, they are, in short, in integral part of the apparatus through which most governments directly or indirectly implement economic policy. This makes banks insiders in the relevant policy communities.

The institutional power deriving from banks’ membership in these policy communities, in turn, allows them to further solidify their market position by regulatory means; at the least, preferential access to political resources forms a de facto insurance against unwelcome market intrusion by firms outside the group of market incumbents—both domestic and foreign. The relationship is reciprocal, then: market incumbency generates the political resources to reproduce itself.

**Integrating markets**

Of course, this depiction of state-market dynamics vastly overstates market stability. In past decades, the trend has clearly been in the direction of market opening, not only in financial markets but across a wide range of economic sectors. How can such liberalization be squared with an emphasis on firms’ own control over the terms of competition? The answer lies in the negotiated character of much market opening, whether through the World Trade Organization, regional trade agreements, bilateral agreements or agreement on common standards such as financial regulation as in the case of this thesis (Abbott and Snidal 2001).
The fact that much regulatory change with market-opening effects is negotiated gives it a quality akin to trade politics (cf. Busch 2001). When market-opening is reciprocal, the most competitive firms in all jurisdictions involved stand to gain, commonly at the expense of smaller players with a domestic focus (cf. Krugman 1986). Cross-border market integration by regulatory means may therefore once market incumbents have reached domestic limits to growth and identified cross-border expansion as they way ahead (Milner and Yoffie 1989). Because the price to pay—increased competition ‘at home’—is disproportionately borne by smaller firms, coalitions in support of opening may emerge in all jurisdictions involved. The European Roundtable of Industrialists, a vocal supporter of the single market project in the late 1980s, has been repeatedly analysed in this vein (Sandholtz and Zysman 1989, Cowles 1995, van Apeldoorn 2002).

*Supranational governance*

In this context, supranational institutions matter because they affect the ease with which such cross-border market-opening can be attained. This much is undisputed even among liberal intergovernmentalists (Moravcsik 1993). Supranational institutions lower transaction and monitoring costs and solve collective action problems (cf. Scharpf 1997a). The agreement of harmonized rules, one of the most common and far-reaching forms of cross-border market integration, has such a potential for distributive bargaining that some degree of centralized authority can greatly enhance efficiency in finding a workable compromise.

That is not the only reason that firms interested in market integration push for supranational governance. Because supranational bodies themselves enjoy room for manoeuvre in policy-making, they provide an opportunity for actors with a stake in supranational governance to build alliances with what are in this respect natural allies. Indeed, as policy-making is transferred from the national to the supranational level, the influence of pro-integration actors rises whereas that of its opponents, who still rely on national governments, decreases. The installation of supranational bodies is more than just adding an extra layer of governance that
otherwise leaves patterns of governance unaltered. It is the formalization of political authority at a level of aggregation that matches the interests and market structures subject to these institutions. It is, in short, a transnationalization of the state in the face of altered competitive dynamics in the market place.

Structuration dynamics

This feedback between patterns of governance and market structures gives structuration its momentum. Market structures inspire actors to reproduce political institutions or work towards their transformation depending on the impact that rules made through these institutions have on the competitive landscape. Changes in the competitive landscape, in turn, affect both the economic might of firms—including their (potential) status as a market incumbent—and associated with that the political resources they command at different levels of governance. The overall model is graphically summarized in figure 2 on the following page.

Because structuration is not ruled by a single dynamic (cf. Cerny 2006), equilibriums between structures and agents' place in them are likely to be temporary, if they exist at all. Even the 'fit' between the nation state and the global economy of embedded liberalism (Ruggie 1982) was more transitory than is often suggested (Frieden 1991, Cerny 1995). The Bretton Woods system, the pinnacle of this order in financial markets, was fully operational for no more than a decade before countervailing forces and underlying tensions inspired the US to initiate its demise in the late 1960s (Eichengreen 1998). Because change in political institutions is typically relatively abrupt, the co-evolution of the two can nevertheless be conceptualized as one of ‘punctuated equilibriums’ (True et al. 1999, cf. Krasner 1984, Crouch and Farrell 2004). With a new set of political institutions created at the supranational level, it may be that at least for the time being, patterns of governance have settled into a stable state converging around the bodies of the European Union. Whether, when and how market transformations may inspire agents to upset this institutional arrangement yet again will be for future research to show.
Figure 2: A schematic depiction of EU financial market structuration
Even though the supranationalization of governance is the explanandum of this study, it is seen as one side of the transformation of what Underhill (2003, see also Underhill and Zhang 2005, Underhill 2007) has called the state-market condominium. Figure 2 is a flow-model of structuration dynamics for capital market governance. Actors’ preferences, filtered by political institutions, are turned into regulatory policy, which affects economic behaviour and thus overall market structures. Changes in this economic environment can, in turn, affect actors’ preferences. As the figure shows, two factors are denoted as ‘distinct but interdependent’. In practice, the distinction between factors that are endogenous and exogenous to a dynamic is less clear cut than the dichotomy suggests (cf. Jervis 1997). Global market developments are not separate from EU trends, especially in capital markets, where London currently challenges New York as the most important global financial centre (Corporation of London 2005, McKinsey 2007). European financial markets are not footnotes to global finance; they are central to it. And as has been elaborated above, varieties of capitalism can inform actors’ preferences and leave their imprint on domestic and eventually cross-border political institutions, even as comparative political economists debate the degree to which they have fallen prey to economic globalization and the transformation of financial markets.

Conclusion

The competition politics framework that this chapter has elaborated aims to connect abstract notions of structuration in political economy with concrete insights from a broad range of theoretical literatures, including those dealing with European integration, financial liberalization and regulation, policy-making, the emergence and functioning of political institutions and national varieties of capitalism. In addition to showing how theories from these fields can be synthesized, the competition politics approach generates four specific contributions to our understanding of political economy that return throughout the thesis.

First, the governance of financial markets—both in terms of substantive regulation and governing institutions—is the product of an elitist form of private interest politics. To be sure,
private actors have to forge successful alliances with public actors to achieve their aims. But as this chapter has argued, financial market incumbents typically command sufficient institutional power to do so. This emphasis on insider politics contradicts both the idea that financial market governance was guided by an overarching collective interest or that it was the outcome of a political struggle among broad coalitions.

Second, such private interest politics generate a dynamic that can be called ‘competition politics’. Firms’ regulatory preferences are primarily informed by their desire to control and manage the competitive landscape within which they operate, rather than for example profit maximization. Socio-economic approaches have emphasized the stability in market structures that can result from regulation as an instrument for restraining competition (Fligstein 2001). The approach advocated here, in contrast, sees competition politics both as an instrument for the reproduction of existing market structures and as a force behind cross-border governance and market integration.

Third, this dynamic defies simplistic categorizations that see either structural forces at work or a small group of agents designing market structures at will. Rather, competition politics is an instance of market structuration: actors simultaneously use both economic and political resources to affect the market structures they confront in line with their preferences. At the same time, actors’ policy preferences and the resources they command to further them are influenced by the political and economic market structures within which agents operate. Changes over time in the political institutions that govern markets, including supranational integration, thus need to be analysed with an eye both for the way in which agents’ preferences shape structures (collectively binding rules, political institutions and markets) and the way in which these structures inspire and constrain agents.

Fourth, the resulting stance on supranational integration emphasizes actors’ material interests and the transnational political-economic context in which they are embedded; at the same time, it highlights the open-endedness of the interaction between market structures and
patterns of governance is central to competition politics. This weighting of material interests challenges approaches that see free-floating identities, the supranational loyalties of bureaucrats, the independent effects of institutions or the more efficient provision of public policy as the driving forces behind supranational integration. The approach is transnational in scope because both the competitive dynamics at play as well as the patterns of political association and exercise of power defy the liberal intergovernmentalist notion that member states and their governments were still the core actors in EU integration. And it is open-ended because the attendant complexities, uncertainties and unintended consequences infuse supranational integration with more vagaries and internal contradictions than transnational historical materialists allow. Indeed, it is precisely this non-linearity of supranational integration that motivates the empirical tracing of supranational capital market governance back to its origins in the mid-1980s—the point at which the following chapter will pick up the historical thread.