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The Microeconomics of Market Regulation A Critical Perspective from the other Social Sciences?

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This special issue starts from the observation that the microeconomic foundations of the theory of regulation have received in recent years more and more attention from other social sciences. The Dutch Ministry of Economic Affairs therefore asked scientists from these other disciplines to write position papers on specific topics. The issue contains contributions by experimental economists (Potters, Krause and Kröger), by a sociologist (Arts), by moral philosophers (Graafland and Smid), by a psychologist (Poiesz) and by lawyers (Hancher, Larouche and Lavrijssen). Together the articles give a good idea about the richness of insights that is present in these other disciplines.

The question to what extent the government (the state) should intervene in the working of the market and how it should intervene has always figured among the most important questions in economics from its very origin. Oversimplifying one could say that three important features characterize the microeconomic foundations laid for this market regulation after the Second World War. First, the theory starts from the background of the Arrow-Debreu model of perfect competition resulting in the first welfare theorem stating that the market under certain conditions leads to a Pareto-efficient outcome. Second, it focuses on optimal government intervention in the case of so-called market failures, i.e. situations in which the conditions enumerated in the first welfare theorem do not hold: imperfect competition, externalities, public goods, increasing returns to scale. Third, it (often implicitly) assumes that the government can be seen as a social planner trying to apply the prescriptions of economic theory as well as possible. Together this is the kind of economic framework that is still present in most introductory textbooks and (therefore?) still has a large influence in the real-world political debate. It is also more or less the "orthodoxy" to which most of the articles in this special issue are reacting.

But is it still the orthodoxy in economic research? Reading the contributions from other disciplines in this issue will induce a strange feeling among economists who follow the academic research on the topic. They will recognize most of the ideas and probably be sympathetic to most of them. Indeed, present economic research has started questioning all three features of the old orthodox approach sketched before. Game theory has introduced a focus on social relations, on norms, on the possibility of multiple equilibriums. Theories of asymmetric information have resulted in new insights into the causes of market failures and have drawn our attention to deep coordination and incentive problems and to the importance of governance structures. Experimental economics has pointed out the importance of concrete institutions and raised questions on how to interpret economic rationality. Welfare economics has questioned the exclusive focus on Pareto-efficiency (interpreted in terms of individual utility). Public choice scholars have destroyed the naive idea that governments behave like perfect social planners. All in all, it seems that there is no longer a large gap between the "new orthodoxy" in economic research and the research on economic topics in the other disciplines. That is why I put a question mark behind my subtitle.

I think that this description of the situation in economic research is not only my subjective reading of the facts, partly based on wishful thinking. Let me support my view with two "objective" (albeit very primitive) indicators. Nobel Prizes in Economics have been awarded to game theory (Harsanyi, Nash and Selten in 1994), to the theory of asymmetric information (Akerlof, Spence and Stiglitz in 2001), to experimental economics (Kahneman – a psychologist! – and Smith in

2002), to unorthodox welfare economics (Sen in 1998), to public choice (Buchanan already in 1986). Surely, this gives an indication of the reputation of economists within the discipline?

Consider as a second indicator the topics of the prestigious plenary lectures given to the Annual Congress of the European Economic Association (EEA): the Presidential Address and the Schumpeter and Marshall lectures. When one looks at the topics of these lectures for the last 10 years one finds all the topics enumerated before. I will not give an overview here, but all the references to the economic literature in this introduction will be to these lectures. Surely, the economists invited for these lectures are at the forefront of research?

All this is definitely *not* to say that interdisciplinary communication is not useful or that economists know already everything, which is to be known on the topic of markets and regulation, and cannot learn much from the other disciplines. Quite the contrary. It is to emphasize that the time is ripe for fruitful contacts between the different disciplines. This requires of course that scholars in these disciplines are aware of the growing "new orthodoxy" in economics – and accept that many, though not all, of their insights can be integrated in the perspective of a broadened methodological individualism. It also requires that economists are not overly critical for the sometimes less formalized and more qualitative reasoning in other disciplines and keep an open mind for the fascinating richness of empirical facts and theoretical challenges, which they offer.

When looking with some distance at the debate about the role of government in markets, one cannot be but struck by the way the ideas about this topic have developed over time: "It is far from a uniform progression of ideas converging on a more complete set of hypotheses about what the state can and should do to promote development. It resembles instead the swing of a pendulum, from one set of ideas which give primacy to the role of the government over markets to another stressing the advantages of markets over the government – and then back again" (Rodrik (1997) 412). Rodrik applies his pendulum idea to the specific topic of the role of the state in economic development, but it is equally applicable to the topic of market regulation in the developed countries. He is quite optimistic about the future development of theory: "The good news is that (...) this time the pendulum has a fairly good chance of stopping at some reasonable midpoint before going all the way to yet another counterproductive extreme" (Rodrik (1997) 413). Both interdisciplinary communication and the further elaboration of economic research along the lines of what I called the "new orthodoxy" will be necessary for that optimistic view to come true.

This is not only important from an academic point of view. General ideas about the role of government and specific methods for analysing the impact of regulatory measures have always had a strong influence on the policy decisions taken by governments – and hence on the welfare of citizens[1]. One can therefore hope that better insights into the working of markets and into the effects of regulation will also lead to better policy. I will now give a brief overview of the different articles in this issue, with a focus on the most important theoretical insights. Policy implications will be the main topic of the concluding article.

THE ROLE OF INSTITUTIONS AND NON-MONETARY INCENTIVES

The article by Michaela KRAUSE, Sabine KRÖGER and Jan POTTERS is an interesting starting point. It gives an overview of different results obtained by experimental economics – a domain that has started occupying a prominent place in the academic economic research of the last decades[2]. The authors start by making an explicit distinction between the "environment" (consisting of the economic agents and their characteristics) and the "institutions" (defining the rules of action and interaction). They show how crucial these institutions are for explaining many of the experimental results, not in the least where asymmetric information and externalities are involved. They draw the conclusion that economic theory seems to overstate the importance of material incentives and undervalue the role of social norms and intrinsic motivations.

It is striking how most of these findings are echoed in the other contributions. The importance of very concrete institutional features is by now also largely recognized in economic theory. This has obvious policy implications. A nice example is offered by Klemperer (2003) who analyses the organizational details of the 3G spectrum auctions in different European countries and links these details to the results of the auctions: the differences are striking (and a good organization of the auction is worth a huge amount of Euros). As Potters et al. argue (and Klemperer acknowledges), well-designed experiments may be very helpful in getting a better understanding of the implications of detailed institutional features.

MARKETS AS SOCIAL NETWORKS EMBEDDED WITHIN A SET OF SOCIAL INSTITUTIONS AND CONVENTIONS

In his article Wil ARTS focuses on the "new economic sociology" of market regulation. This new economic sociology draws a broad picture in which the more specific experimental results can be integrated. Markets must be seen as a network of social relationships in which trust, reciprocity, friendship and power play a crucial role. Moreover, they are embedded within a system of norms and conventions. This system of norms and conventions can be called a "culture" and is not the same for all times and countries. The political system – the state- is a central element in all this. Modern states establish rules and social institutions necessary to let markets work: property rights, governance structures, rules of exchange.

Arts himself is very well aware of the close relationship between economic sociology and modern economic theory. He mentions that the analysis of social norms, institutions and organizational practices is the main cornerstone of the new economic research program (which he calls the post Arrow-Debreu program). Arts presents some empirical work and applies his ideas to an analysis of the development of the European single market. Another nice empirical application in a very different domain is in Bewley (1998) who asks the crucial question: why not cut pay? His survey results show how important social and cultural factors, values and norms are for the determination of wages in modern market economies. The consequences for economic policies with respect to income distribution and with respect to the labour market are obvious.

REPUTATION AND CORPORATE SOCIAL RESPONSIBILITY

In a certain sense the next article by Johan GRAAFLAND and H. SMID can be seen as another concrete application of the general framework sketched by Arts. Graafland and Smid first describe theoretically how implicit self-enforcing contracts may be a substitute for explicit legal contracts or for government regulation. They argue that the reputation mechanism can in principle be very important for the enforcement of such implicit contracts. The central question in their paper is whether this reputation mechanism in reality provides enough incentives for companies to take up their corporate social responsibility. On the basis of an extensive overview of the empirical work they conclude that the mechanism does work but that government regulation remains important, especially with respect to the creation of more transparency.

The richness of empirical findings summarized in Graafland and Smid directly pertains to concrete enterprise behaviour. It can be linked, however, to the large (and rapidly growing) theoretical literature on the importance of norms in the context of repeated games, even with purely self-interested individuals. As noted before, recent experimental results even suggest that it is necessary to go beyond self-interested pecuniary motives. In this respect Fehr and Falk (2002) show the importance of the motive to reciprocate, i.e. the desire to respond to friendly or hostile actions by similar reactions, even if no immediate material gains can be expected. They also show how difficult it is to understand economic behaviour if one does not take into account the motives to gain social approval and to avoid social disapproval. All this is of course closely related to the working of the reputation mechanism. It also brings us to the fourth paper in this special issue.

ENLARGING THE NARROW MODEL OF THE "HOMO ECONOMICUS"

The article by Theo POIESZ is probably the most difficult one for economists to digest. It starts from the idea that a precondition for the good working of markets is consumer rationality, interpreted in a substantive way (including perfect information, full understanding of all consequences of decisions and even incorporation of the long term, social and societal consequences of the choice alternatives). Poiesz argues that such rational choice is a rare phenomenon. The most fascinating part of his paper is the prediction that in the future new marketing systems will appear to bridge the gap between consumers and producers: he calls these "Virtual Guardian Angels" (VGA). Consumers will delegate those decisions to the VGA for which they do not have sufficient motivation, capacity and opportunity, while at the same time keeping complete freedom to decide whether they will join a VGA.

Poiesz works out the implications of these developments for government regulation in the future.

No reasonable observer will deny that the substantive rationality described by Poiesz is indeed a rare phenomenon. But this begs the question of how to integrate the various psychological findings into a coherent and parsimonious model of human behaviour, and more specifically how far we can get with an extended interpretation of the "homo economicus" with complicated preferences and bounded rationality (Rabin (2002) Selten (1998)). This question of the articulation of the relationship between psychology and economics is one of the most important topics in current economic research. As Tirole (2002) states in his Presidential Address for the European Economic Association on "Rational irrationality": "I am reluctant to take a position on the future of psychology and economics. We are still in the exploratory phase and any stance runs the risk of pushing the field in the wrong direction. It is important, even crucial, to 'let a thousand flowers bloom'; there will be plenty of time for the shake-out period later on."

PRINCIPLES OF GOOD MARKET GOVERNANCE: NETWORK INDUSTRIES

The next article in this issue (by Leigh HANCHER, Pierre LAROUCHE and Saskia LAVRIJSSEN) focuses on the general principles of good market governance and applies these principles for a critical analysis of government regulation in network industries like the electricity, the telecommunications and the postal sector. Their detailed analysis of the legal framework is a useful complement to the economic analysis of these network industries (Newbery (1997)) and is also perfectly in line with the focus on concrete institutional features, which is so prominent in the other articles in this issue.

Perhaps we should go even further and analyse more explicitly the limitations of government regulation by focusing on incentives and information problems within the government sector itself. How should we design electoral systems so as to optimise the impact of voters on decisions (Myerson (1999))? How should we design government intervention so as to avoid the capture of politicians and bureaucrats by interest groups (Laffont (1999))? The answers to these questions are not only relevant for a general position on government intervention; they also influence the optimal choice between specific regulatory measures.

CONCLUSION

The different contributions in this special issue show convincingly that economists do not have the monopoly to think about the regulation of markets by government and that other social sciences have made important contributions to the debate. Their insights are perfectly in line with what I have called the new orthodoxy in economic research – an approach emphasizing information and coordination problems and showing the relevancy of social norms and non-pecuniary incentives. There is much room for fruitful interdisciplinary communication. Of course, the insights from the articles in this issue are not only relevant from an academic point of view. They also lead to a renewed view on practical policy matters. The policy implications of the articles are discussed in the concluding paper by Anne REITSMA, Stephan RAES, Erik SCHMIEMAN and Pieter VAN WINDEN.

NOTES

1. At the same time there is of course a two-way influence: ideological developments and evolving power positions in the real world have also a clear influence on the direction taken by social scientific research.
2. Using my EEA-test I refer to Fehr and Falk (2003), Rabin (2002), Rubinstein (2001) and Selten (1998).

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