

## QUICK READ SYNOPSIS

The Rise of Regulatory Capitalism:  
The Global Diffusion of a New Order

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SECTION ONE: GLOBALIZATION AS A  
DIFFUSION PROCESS: THEORETICAL FRAMEWORK

The Global Diffusion  
of Regulatory Capitalism

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and the University of Haifa

*Background*

This article looks at the rise and diffusion of regulatory capitalism. Regulation seems to be the wave of the future, and the current wave of regulatory reforms constitutes a new chapter in the history of regulation. Regulation is both a constitutive element of capitalism and the tool that moderates and socializes it.

- It suggests that change in governance of capitalist economy is characterized by
  - a new division of labor between state and society (privatization);
  - an increase in delegation;
  - proliferation of new technologies of regulation;
  - formalization of regulation; and
  - growth in the influence of experts, especially international networks of experts.

- Regulation, though not necessarily directly by the state, seems to be on the increase despite efforts to redraw the boundaries between state and society.
  - It is no longer about the delegation of authority to elected representatives, but a form of second-level indirect representative democracy—citizens elect representatives who control and supervise experts who formulate and administer policies.

*Regulatory  
Capitalism*

The new order of regulatory capitalism represents a new division of labor between state and society, and in particular between state and business.

- In regulatory capitalism, the state does the steering, while business takes over the functions of service provision and technological innovation.
- There is an increasing reliance on mechanisms of self-regulation in the shadow of the state.
- New regulatory institutions, technologies, and practices are increasingly embedded in the complex structures of modern capitalist nation-states.
- The current rise of regulatory capitalism is also about the spread of certain techniques of control more from one sector to another, not only from one state to another.
- The notions of regulation and governance through rule making and rule enforcement are essential if we are to bring the state back in once again in our era of globalization.

*Regulation*

While neoliberalism gave strong impetus to regulatory reform, regulation should not be considered as a mere balancing act to the rise of neoliberalism.

- While most regulatory agencies are committed to the promotion of competition, the degree to which this competition is enhanced by regulation is giving these policies a neomercantilist rather than a liberal character.
- Regulation is helping to legitimize markets and facilitate transactions by enhancing trust.

*The Audit  
Society*

Auditing won a degree of stability and legitimacy that institutionalized it as a major tool of governance well beyond the control of business.

- The augmentation of auditing practices creates the “audit society” and dramatizes the extreme case of checking gone wild (Power, as cited in the article).
- Regulatory growth, as Power suggests, is not only an answer to the problem of political control over the economy but represents the demands for legitimacy and trust and the difficulties involved in accepting and dealing with risks.
- The demand for and the supply of regulation shape the way we act, and we can take Power’s analysis as an indication of the growth of regulation outside the scope of neoliberalism.

*Regulatory  
Instruments*

Another indication of the new order of regulatory capitalism is the proliferation of regulatory instruments to ensure corporate social responsibility.

- In the past two decades, we have seen the increase of tools for integrating social justice and environmental protection issues into the governance structure of corporations.
- These tools include environmental management systems, corporate reporting systems, codes of conduct, third-party certification systems, and ethical investment.
- Domestic regulations and self-regulation are exploding, and the demands on corporations seems only to increase the sphere of internal regulation.

Q  
R  
S*Diffusion*

NOTE: The notion of regulatory capitalism that rests on a new division of labor between state and society, on the proliferation of new regulatory agencies, and on new technologies and instruments seems to open an agenda that may well become a major area of social, economic, and political research.

Diffusion is the process by which the adoption of innovation by members of a social system is communicated through certain channels over time and triggers mechanisms that increase the probability of its adoption by other members who have not yet adopted it.

- What is readily observed as an outcome of both structural and diffusion processes of change is “clustered behavior”—what may on the surface look like a diffusion process is not necessarily driven by mechanisms of diffusion.
- With the growth and expansion of communications and transport technologies, we can expect interdependencies to be even more important forces of change.
- Closely related is the policy transfer approach to change, which is the process by which knowledge about how policies, administrative arrangements, institutions, and ideas in one political setting is used in another political setting in the development of change.
- A diffusion perspective suggests that regulatory order that was shaped in some leading countries and sectors is then diffused to the rest of the world.

*Diffusion Approaches*

It is useful to distinguish horizontal from top-down and bottom-up approaches of diffusion.

- Top-down explanations discuss the advance of regulatory reforms as a response of national policy makers to exogenous pressures from various international sources.
- Bottom-up explanations examine the advance or stagnation of reforms as the outcome of domestic balances of power and specific national styles.
- The horizontal approach to change treats the decision to adopt regulatory reform as an interdependent decision that is taken within a group of policy makers who closely observe each other:
  - The observation of regulatory reform in one sector increases the probability of reforms being adopted in other sectors in the same country and in the same sector in other countries.
  - Their mutual interdependency in decision making suggests that policy makers are subject to incentives from their fellow policy makers in varied domains of action.

*Conclusions*

The order of regulatory capitalism portrayed in this article varies in three major respects from conventional wisdom.

- Regulatory capitalism conveys a conception of change that is more specific than notions such as the “new world order,” the “retreat of the state,” or the rise of neoliberalism.
- It examines changes as a diffusion process.
- It diverges in its approach to power and distributional issues from both the advocates of freer markets and their opponents.

NOTE: It is suggested that the notion of a new order of regulatory capitalism goes beyond privatization and includes an increase in delegation to autonomous agencies, formalization of relationships, proliferation of new technologies of regulation in both public and private spheres, and the creation of new layers of both national and international regulation.

- It is suggested that the new order is diffused rather than reproduced independently in each country:
  - ◻ Diffusion is a reflection of an increasingly interdependent world.
  - ◻ There is an increase in the export and import of institutions and knowledge.
  - ◻ It can be observed in a social and network context with “knowledge actors.”
- Regulatory capitalism is much more open to collective action than is usually portrayed by both advocates and opponents of freer markets.

## On Waves, Clusters, and Diffusion: A Conceptual Framework

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and Beth Simmons, Harvard University

### *Background*

The research on democratic and neoliberal diffusion is decidedly limited, but growing.

- Scholars are attempting to track the patterns and sequence of adoption of democratic and liberal economic reform.
- There is a renewed interest in refining econometric measures to estimate spatial and network effects.
- This article contributes to the theoretical and conceptual component of the research, and the goal is to suggest a framework for future research.

### *Policy Clustering*

Diffusion research is motivated by the observation that nation-states, or some other jurisdictional units, choose similar institutions within a fairly circumscribed period of time—described as policy clustering.

- One reason is that countries respond similarly, but independently, to similar domestic situations.
- A second alternative is that clustered policy making is coordinated by a group of nations, a hegemonic power, or an international organization.
- A third combines an element from each of the above:
  - It is a set of processes characterized by interdependent, but uncoordinated, decision making.
  - Governments are independent in the sense that they make their own decisions without cooperation or coercion but interdependent in that they factor in the choices of other governments.

### *Diffusion*

Diffusion is not an outcome, but it is the term for a class of mechanisms and processes associated with a likely outcome.

- The implication is an interdependence among units such that the adoption of a practice by one entity alters the probability of adoption by another.
- Diffusion is an important subtype of international factors characterized by the lack of coordination among those involved.
- Diffusion mechanisms are of two kinds:
  - those for which another’s adoption alters the value of the practice—*adaptation to altered conditions* (examples are cultural norms, support groups, and competition); and
  - those for which another’s adoption provides information—*learning*.

*Learning*

What is interesting about learning from a diffusion perspective are the numerous ways it can go wrong.

- Information cascades, which are the accumulation of the wisdom of other individuals' decisions, may be good or bad for an individual's new decision.
- Availability refers to the difficulty in retrieving a full sample of information and thus making decisions on what is available at the time.
- Reference groups refers to decision makers paying more attention to policy models in countries similar to theirs, and they will align their policies with those countries.

NOTE: In spite of the above risks, it appears that countries will do better for themselves by searching for information internationally than if left to their own devices. A second factor is their level of commitment and internalization for reform.

*Implications*

Part of the intrigue is that diffusion implies that governments are making choices that they would not make if left to their own devices.

- Policy detours may mean that governments adopt suboptimal or inappropriate policies designed for the needs of others or optimal policies they cannot engineer themselves due to lack of resources.
- The question is whether diffusion is responsible for a nation's squeezing into ill-fitting but fashionable institutions or whether it leads them to the most functional or efficient ones available.

NOTE: We can expect diffusion to have very different implications for social welfare according to the particular mechanism at work. Identifying the mechanisms of diffusion, in this sense, takes on more importance than a simple accounting of historical sources. Understanding the path to institutional reform tells us much about the probable performance of the reform.

## Regulatory Capitalism as a Networked Order: The International System as an Informational Network

David Lazer, Harvard University

*Background*

This article asks what governance issues are raised by viewing the international system as an information network and documents the diffusion of policies across nations.

- The challenge is to balance the benefits of eliminating costly reinvention while maintaining continuing innovation and minimizing the dissemination of welfare-reducing policies (fads).
- Increases in the linkages in the system may decrease innovation and increase fads.
- The tug and push of the international environment is more evident now than ever through international agreements, desires to attract international capital, and needs to have compatible policy regimes with major trading partners.
  - The international environment also provides information as to what are desirable prices.

- It is useful to see the international system as an information network where information is produced and processed and where linkages between units serve as information conduits.
- Technology has greatly aided the dissemination of information with greater accessibility of information to decision makers.
- It is plausible that such increased accessibility will decrease investments in innovation as decision makers wait for other jurisdictions to create policy solutions and increase the spread of misinformation (fads).

*Diffusion*

States, in an information network perspective, are simply policy choosers and information producers.

- Policy makers need to adopt selective attention to help sift information and internal filtering to eliminate the large majority of publicly available information.
- Policy makers have become rich informational nodes in an international network.
- Information diffusion in the public sector has relatively little incentive to suppress information about successful innovations as opposed to what happens in the secretive private sector.
- Bureaucratic inertia is likely the greatest barrier to diffusion.

NOTE: There is substantial potential for diffusion of successful policy innovations, both intranationally and internationally.

*Types of Diffusion*

There are several types of information diffusion:

- Epistemic communities—cross-national collectives of individuals with common interests and institutionalized mechanisms for communication.
- International organizations—the availability of information influences policy. As an example, the Organization for Economic Cooperation and Development (OECD) played three roles for diffusion in the case of the Government Performance and Results Act of 1993:
  - It defined a menu of policy options.
  - It provided evaluative information.
  - It provided the best examples.
- Cross-national corporate entities—these have political interests in their own country and push for compatible cross-national standards.
- Institutionally mediated—mechanisms proscribed for sharing of information such as in the EU.
- Peer to peer—ad hoc relationships between policy makers that create information flow.
- The Internet facilitates the broadcasting of policy information and facilitates the maintenance of peer-to-peer networks.

NOTE: Although having more information appears to be a good thing, there are three important caveats:

- Increasing dissemination of information may reduce the incentives to produce information.
- It may reduce the diversity of information available.
- It may serve as a conduit for bad information.

*Value of Diversity*

A challenge in the highly networked world is that some diversity of policy solutions will be lost.

- Innovation will rely in part on a government's assessment of policies adopted by other states and whether there is consensus on best practices.
- If a successful innovation is optimal, it may not be optimal in the future, and therefore, maintaining a diversity of approaches is important.

*Aggregating Information*

Another challenge is how well a highly networked world aggregates information.

- Bad information as well as good spreads in the network.
- Fads spread easily.
- Misinformation can be common, and all it might take for the system to get rolling in the wrong direction is for a few of the initial adopters to have incorrect signals.

*Conclusion*

There are a whole series of underexplored issues, including the following four:

- What is the actual architecture of information diffusion?
- What are the motivations of policy makers for innovation?
- What are the implications for who wins and loses from a given change in the network?
- What are the prescriptive governance implications of an information network perspective?

## Policy Learning, Policy Diffusion, and the Making of a New Order

Covadonga Meseguer, CIDE

*Background*

Research on the diffusion of economic and social policies and institutions assumes that an approach based exclusively on the domestic economic and political factors to explain particular dynamics of change is flawed.

- A primary example of this dynamic is the dramatic trend toward liberalization and deregulation in the developing world.
- These changes were seemingly driven by more than just domestic considerations.
- This article focuses on “learning from the experience of others,” which persuaded politicians of the virtues of liberal market policies—this recent convergence toward privatization and deregulation may have its roots in a process of social learning.
- The trend toward a deregulated state seems now to be undergoing a reversal—the trend to bring the state back in as a regulator has to do with the failures of the processes of change by “social learning.”

NOTE: Although learning is suggested as a fundamental mechanism of diffusion of the previous wave of deregulation and privatization and of the current wave of regulatory reforms, we still lack the empirical tests to evaluate the impact that learning may have had on these trends.

*Learning and Diffusion*

The argument that a learning process generated the spread of liberal economic policies during the 1980s and 1990s is well established.

- These reforms aimed to open up national economies and reduce the economic role of the state through privatization, deregulation, and support for property rights.
- This model of development came to replace years of active state intervention and inward-looking development of most developing countries’ policies.
- Learning from failed and successful experiments was crucial to the adoption of market reforms.

- Just as policy failures provide information about what not to do, good performance or policy successes provide information about alternative courses of action.
  - Latin American policy makers saw the growth in Asian countries and became convinced that opening of the economy was the best way to produce a real transformation.
  - It does make sense to hypothesize that learning from previous experience with deregulation and with current experience with regulation explains the regulatory state beyond the United States and Europe—although proving this hypothesis is difficult.

*Policy Diffusion Debate* Learning is considered a horizontal mechanism of diffusion because policy is passed from one nation to another by means of influence.

- Governments find it relatively simple and inexpensive to observe the results of particular policies in other countries and then to adopt “good” policies.
- Learning can be rational or bounded, but both entail a search for solutions.
  - If rational, it assumes government officials scan all information regardless of its origin and draw conclusions about relative merits of different policies.
  - Bounded learning entails particular cognitive shortcuts using just relevant information.
- Politicians do not attach the same weight to all information and particular pieces become more representative than others—for example, initial success is frequently given more weight than rational learning would predict.

NOTE: There are two challenges—first, how to measure learning; and second, how to measure emulation.

*Rational Learning*

Rational learning begins with the assumption that people have prior beliefs about which outcomes are expected from a particular policy.

- Beliefs may be based on policy ideas or on previous experience of policies.
- Politicians learn rationally only if they take all information into account about policies elsewhere and use that information to revise their beliefs.
- Rational learning needs to take into account the quantity and quality of the information (Bayesian learning).
- The strength of this approach lies in its ability to predict behavioral outcomes—regardless of prior beliefs, policy makers will converge on their posterior beliefs, which are dominated by observed experience.
  - If experience is scant, or variations in outcomes are high and/or prior beliefs are strong, then observed experiences carry less weight.
  - In such circumstances, prior beliefs may still dominate the revising process, precluding convergence on posterior beliefs.
- Applying the concept of rational learning in practice is quite demanding and complex.
  - Choices have to be made about how to operationalize prior beliefs.
  - One also has to model the kind of results politicians look at in their attempt to learn from others’ policy experience.

*Bounded Learning*

Kurt Weyland, as cited in the article, defended the argument that bounded learning overrides rational learning when it comes to explaining the adoption of market reforms.

- Weyland’s research demonstrates that while politicians do actively seek solutions by purposive search, their search is biased by the use of particular cognitive shortcuts—that is, not all information is perceived as equally useful.

Q  
R  
S*Herding  
Behavior*

- Governments look at what is close (availability heuristics), they favor initial successes, and they limit the number of changes in the implementation of foreign policy models.
  - There is little support to show learning proceeds in a rational fashion.
  - The bounded learning hypothesis receives stronger backup.

NOTE: Bounded learning may best be suited to explain policy divergence rather than convergence, and it may also provide a likely model in explaining different methods of carrying out the same policies (divergence within convergent policy choices).

The empirical testing of herding behavior seems to be less controversial—emulation has been widely tested and supported by the data.

- One way to test herding behavior is to include the sheer number of countries carrying out a particular policy—the more that adopt a policy, the more favorable the climate of opinion in favor of that policy.
- The evidence of the impact of herding or emulation on policy choices and diffusion is quite overwhelming.
- It appears that politicians interpret the available information through the same lenses, and this explains convergence in spite of all the possible biases that might exist.

NOTE: Further research should be devoted to refining the operationalization of both learning and emulation and to incorporating learning from political variables as a logical, obvious, and necessary extension.

## SECTION TWO: THE DIFFUSION OF ECONOMIC REGULATIONS

## The Institutional Foundations of Regulatory Capitalism: The Diffusion of Independent Regulatory Agencies in Western Europe

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*Background*

This article studies the diffusion of independent regulatory agencies (IRAs).

- Three classes of factors explain this trend—bottom-up, top-down, and horizontal.
- The establishment of IRAs was an attempt to improve credible commitment when liberalizing and privatizing utilities and to alleviate the political uncertainty that comes when governments change.
- Governments were influenced by the decisions of others in a diffusion process where the symbolic properties of the regulators mattered more than the functions they performed.

*Bottom-Up  
Diffusion*

There are two main pressures for the bottom-up creation of IRAs.

- Credibility—linked to the fact that investors need regulatory stability; IRAs can help keep policies consistent.
- Political uncertainty—linked to policy changes that could occur when governments change or a new party gains power.

<i>Top-Down Diffusion</i>	<p>Top-down explanations for the establishment of IRAs discuss the advance of regulatory reforms as a response of national policy makers to pressures from various international sources.</p> <ul style="list-style-type: none"> <li>• An example is in the EU making rules for institutional compliance.</li> <li>• The EU requires that member states ensure effective structural separation of the regulatory functions from activities associated with ownership or control.</li> </ul>
<i>Horizontal Diffusion</i>	<p>Horizontal explanations focus on interdependencies among countries that cause diffusion processes.</p> <ul style="list-style-type: none"> <li>• Several diffusion mechanisms exist, including learning, competition, cooperation, and the following: <ul style="list-style-type: none"> <li>• taken-for-grantedness—some policies become taken for granted as the normal solution to a problem, and</li> <li>• symbolic imitation—adoption of some policies is a ceremony intended to legitimize the actions of the adopters.</li> </ul> </li> </ul>
<i>Credibility and Political Uncertainty</i>	<p>Both credibility and political uncertainty pressures are expected to be filtered by political institutions that impose constraints on decision-making processes, since they are functional equivalents of delegation for coping with both problems.</p> <ul style="list-style-type: none"> <li>• Included in the process are veto players whose agreement is necessary to change the status quo.</li> <li>• Policy stability increases as the number of veto players increases; they are able to moderate both credibility and political uncertainty pressures.</li> </ul>
<i>Conclusion 1</i>	<p>This article shows that the three classes of explanations for diffusion all matter in the diffusion of IRAs.</p> <ul style="list-style-type: none"> <li>• In respect to the bottom-up hypothesis, the need to improve credible commitment when privatizing and liberalizing utilities increases the likelihood that an IRA will be established. Likewise, the establishment of IRAs is more likely in the presence of political uncertainty.</li> <li>• In the top-down perspective, Europeanization matters.</li> <li>• Evidence for the horizontal perspective confirms the hypothesis that individual IRA creations have not been independent.</li> </ul>
<i>Conclusion 2: Regulatory Capitalism</i>	<p>The article raises two issues about the global diffusion of regulatory capitalism.</p> <ul style="list-style-type: none"> <li>• Any explanation that neglects horizontal factors misses an important point—common pressures and imposition by powerful organizations matter, but interdependencies among countries are also a fundamental driver of reforms.</li> <li>• The rise of the regulatory state has a very important social component.</li> </ul> <p>NOTE: An implication of this research is that policy change comes in waves. The wave of utility privatization was preceded by a wave of nationalization. Therefore, although IRAs are now widespread, they may not be here to stay.</p>

## The Diffusion of Regulatory Capitalism in Latin America: Sectoral and National Channels in the Making of a New Order

Jacint Jordana, Universitat Pompeu Fabra;  
and David Levi-Faur, Australian National University  
and the University of Haifa

### *Background*

The global diffusion of autonomous regulatory authorities is the hallmark of the rise of regulatory capitalism.

- It is believed that the appropriate way to govern certain economic sectors and to limit some social risks is through the creation of autonomous regulatory authorities.
- The new practice takes the form of a delegation of power from ministers to arms-length bureaucracies staffed with technocrats and professionals.
- This new approach to public policy delegates authority to regulators who in turn enjoy considerable autonomy in the formulation and administration of policies.

The rise of regulatory capitalism in Latin America take place in context of three related factors:

- the crisis of developmental model in the region,
- sweeping economic liberalization, and
- democratization.

NOTE: This article emphasizes sectoral as well as national variations in the diffusion of regulatory authorities, thus providing an account of the process of change—the dynamics of sectoral diffusion was found to be as strong as, or stronger than, country-level diffusion for the Latin American case.

### *Study Claims*

The results of this study provide empirical support for four claims that touch on the peculiarities of the diffusion of regulatory authorities.

- The decision to establish a regulatory authority is influenced by prior decisions, and we see that global change is produced and conditioned by formal and informal networks of people who monitor each other's activities.
- The process of global diffusion is strongly shaped by international within-sector channels of diffusion. Thus, prior decisions in the same sector by other countries influence each country's decisions for the same sector.
- The process of diffusion is also shaped by within-country channels, and so the probability of establishing a new regulatory authority increases with prior decisions to establish them in other sectors in the same country
- The probability of establishing a new regulatory authority increases slightly more with an increase in prior decisions in the same sector in other countries than with an increase in decisions in other sectors in the same country.

### *Diffusion Perspective*

Why analyze the administrative structures of the Latin American states from a diffusion perspective?

- Diffusion perspective does not require ad hoc revisions due to previous theoretical failures to deal with global change.
- Diffusion perspective has the ability to deal with the compression of space and time that turns countries and sectors that seemed isolated into intercon-

nected and interdependent entities—diffusion theories suggest that all political and social events are highly interdependent.

*Diffusion  
within Nations  
and Sectors*

There are two popular comparative approaches to bridge the gaps between the rich literature of comparative politics and the relatively modest literature on the diffusion of political innovations.

- The national patterns approach (NPA) suggests that political processes and outcomes are shaped by state traditions and that the nation-level community of policy makers has effective control over domestic political processes. In the context of diffusion processes, the NPA expects the process to be shaped by national factors and predicts that the number of other regulatory authorities in a country will determine the probability of the establishment of new authorities.
- The policy sector approach (PSA) emphasizes the autonomous political characteristics of distinct policy sectors and, hence, the multiplicity of political patterns in any one country. In the context of diffusion process, the PSA expects sectors to exert the major influence on the diffusion process and predicts that the establishment of new authorities within a sector will be determined by the number of regulatory authorities in the same sector in other countries.

*Conclusion*

This article examines the rise of the new order from a diffusion perspective and argues that only from this perspective is it possible to explain why so many new regulatory agencies were established or reformed in a short period across so many sectors and countries in Latin America.

- The traditional comparative approach should examine endogenous sources of change, particularly how the probability of adoption of innovations depends on prior decisions of others and peers.
- It is suggested that we move the discussion from the sphere of the power of money to the sphere of the power of ideas.
  - In such a setting, ideas about best practice are diffused through networks of policy makers and knowledge-based communities.
- The authors show the distinction between sectoral and national patterns of diffusion and the formulation of a heuristic that makes it possible to study them together.
- One of the most interesting findings is the diffusion from a sector in one country to the equivalent sector in another and the rather slower diffusion between sectors within one country—the strength of international networks and professional communities, and their specialized nature, may be very relevant factors.

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## Political Insecurity and the Diffusion of Financial Market Regulation

Christopher R. Way, Cornell University

*Background*

Politically insecure leaders are potent agents of diffusion because they are particularly likely to learn the lessons of financial market reform and emulate the liberalizing practices of others.

- The hefty economic boom often associated with financial liberalization provides a tempting way to buttress their near-term grip on power.
- As they see other nations in their region experiencing a boom, insecure leaders will jump on the liberalization bandwagon, accelerating regional reform cascades.
- Insecure governments may be susceptible to pressure from international organizations—they have motivated biases to believe the efficiency claims of liberalizers and strong reasons to seek “a seal of approval” for their policies.

NOTE: Placing the incentives facing leaders into center stage and focusing on the horizontal diffusion of liberalization, the author argues that politically insecure leaders are potent agents of diffusion because they are particularly likely to “learn” the lessons of financial market reform.

#### *Liberalization*

The immediate aftermath of financial market liberalization is often characterized by an economic boom, and this effect is most pronounced in developing countries.

- Loosened borrowing restrictions, new credit instruments, and capital inflows fuel a credit-driven consumption and investment boom.
- The boom can provide an important source of political strength for insecure governments—they thus have a strong attraction to liberalization.
- Politically insecure governments will likely initiate reforms, thus proving to be potent agents of diffusion in the right circumstances.
- Two circumstances facilitate “learning” by insecure leaders:
  - As they observe other nations in their region experimenting with reform, and ideally experiencing a boom, they jump on the bandwagon.
  - They may be particularly receptive to policy advice from international organizations, looking for a semiofficial “seal of approval.”

#### *Political Insecurity and the Quality of Reform*

Most observers agree that prior to freeing interest rates, eliminating credit controls, and deregulating banking, authorities should set up an appropriate regulatory infrastructure.

- This includes establishing a system of prudential regulation and supervision based on sound accounting, strong bank supervision, and capital adequacy requirements—it is reregulation for competition.
- Contrary to this prescription, the norm has been a rush to deregulation and freer credit.
- Based on past market turbulence resulting from poorly executed liberalizations, the average level of prudential regulation has been increasing since the late 1980s.

#### *Reform and Regulation*

The relationship between the diffusion of financial market reform and regulation follows something of a U-shaped relationship over time.

- In the early phases of reform, the emphasis is on removing previous controls and deregulating.
- In later phases, financial market instability spurs greater emphasis on prudential regulation and supervision, resulting in reregulation.
- Thus, the global spread of liberalization does not result in simple deregulation but rather in varieties of regulatory capitalism—in the long run, it represents the spread of regulatory capitalism.

NOTE: The reason for the pervasive failure to prepare the regulatory foundation for successful liberalization is that governments are anxious to gain the benefits of liberalization and that politically insecure leaders will be more prone to this error.

- Macroeconomic View of Reform* Whereas many reform packages promise short-term pain in return for long-term gains, domestic financial market reforms frequently reverse this formula, promising short-term benefits while posing long-term risks.
- The macroeconomic dynamics of liberalizations create temptations for governments with short time horizons to initiate reforms.
  - The immediate aftermath of liberalization is usually an economic boom—this boom can provide an important source of political strength for insecure governments.
    - There is robust GDP growth, expanding employment, and other issues that are likely to improve assessments of government performance.
    - The boost can be large and long lasting.
  - The two chief engines of growth—consumption and investment booms—disperse benefits across broad constituencies; the increase in credit availability fuels consumption with never-before borrowing opportunities, and in developing countries this brings new consumers into the marketplace.
  - Financial constraints for most firms are loosened, and smaller firms have an increased ability to borrow.
- Risks* The boom phase comes with risks that lie relatively far in the future.
- There are often banking sector problems, which often erupt into full-scale crisis sometime within ten years.
  - There is often an overhang of bad loans.
  - The result of these problems is reregulation in the form of efforts to establish and strengthen regulatory institutions—in short, the diffusion of financial market liberalization ends up being the diffusion of regulatory capitalism.
  - Two conduits of diffusion heighten the chance that insecure leaders learn the lessons of reform and attempt policy changes:
    - observance of booms in other countries and
    - IMF participation lending a “seal of approval.”
- Conclusion* This article’s point has important implications both for the literature on financial market liberalization and diffusion of regulatory practices.
- Politically insecure leaders may not be the most effective reformers—they are shown to be the wrong type of government to jump on the bandwagon, tending not to lay the foundations for long-term success and stability.
  - Studies tend to support advocates of a careful, patient sequencing strategy of reform, which are successful in the long run and avoid banking crises—profound reform is that which couples the construction of effective regulatory institutions with a deep commitment to liberalization.

## SECTION THREE: THE DIFFUSION OF SOCIAL REGULATIONS

## The Global Diffusion of Regulatory Instruments: The Making of a New International Environmental Regime

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Freie Universität Berlin

- Background* This article identifies the conditions under which policy choices of one country affect the choices of others. The article looks at
- the spread of environmental strategies, eco-labels, energy taxes, and legal provisions regulating the free access to information;
  - a new generation of collaborative, market, and information-based instruments that has emerged in almost all industrialized countries;
  - the factors that support or hinder adoption of regulatory instruments; and
  - the predominant mechanisms by which policies spread internationally.
- Policy Diffusion* The essential feature of policy diffusion is that it occurs in the absence of formal or contractual obligation.
- Diffusion is basically a horizontal process whereby individually adopted approaches add up to a decentralized regulatory structure.
  - Decision-making processes remain at the national level.
  - Diffusion appears after accumulation of individual cases of imitation or learning with respect to one and the same policy item.
  - International policy diffusion may result in a “regulatory revolution by surprise.”
  - There are three groups of factors that affect diffusion patterns:
    - dynamics of the international system,
    - domestic factors, and
    - policy characteristics.
- Diffusion Process* Policy makers may voluntarily emulate other countries due to a wide range of individual motivations.
- Policy makers may look across borders for solutions.
  - They may be influenced by national, international, or transnational factors.
  - In the latter stages of diffusion, international pressures for conformity are present.
  - Policy makers do not necessarily choose those options that promise the highest level of effectiveness; they also take into account the expected economic and administrative costs.
  - Once policies are adopted by a critical mass of countries, it becomes difficult for reluctant countries to ignore them.
  - Some countries set a domestic example of a policy and use it to influence the international adoption.
  - Finally, instead of manufacturing products with different environmental properties for different markets, countries may choose the highest standard so they can produce just one version.

- Conclusion* Diffusion processes may well be the first step in the emergence of international environmental regimes.
- In the case of environmental strategies, horizontal diffusion accompanied by information and recommendations from international organizations has eventually created a critical mass of adopters.
  - In Europe, basic regulatory ideas have diffused from the national level to the EU level and led to adoption of EU-wide regulations.
  - Promotion at the international level has proven to be a decisive driver of policy diffusion.
  - Policies with high potential for conflict tend to diffuse slowly.
  - In a number of countries, adoptions were not exclusively driven by rational motivations to improve the effectiveness of environmental policies; rather, many adoptions are a response to an international norm that became recognized and internalized by policy makers.

## Standards and Regulatory Capitalism: The Diffusion of Food Safety Standards in Developing Countries

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- Background* The case of food safety provides a strong argument for both the existence of regulatory capitalism and its diffusion via horizontal agents.
- It highlights the power of national differences in the face of common global structural forces.
  - Differing national food safety standards hinder food trade, increasing costs to the consumer.
  - National standards serve as nontariff barriers to trade.
  - Standards conflicts are highly controversial international trade issues.
- NOTE: An international governmental organization called the Codex Alimentarius Commission (CAC) sets food standards that are used by the World Trade Organization (WTO) in dispute resolution.
- Codex* The Codex Alimentarius Commission was created by the UN and the World Health Organization to develop international standards that ensure consumer safety and fair practices in food trade.
- One of the key criticisms of the CAC is that public health takes a backseat to trade interests—as states agree to free their markets to trade, at the same time they reassert their rights to determine their own safety standards.
  - The CAC reflects bargaining and negotiation among a set of well-known countries—individual powerful countries write the regulations and dominate the framing of standards.
- Top-Down Diffusion* The main source of top-down diffusion of standards involves producers in major exporting countries. Two issues occur:
- Producers may want to push for the lowest common denominator of standards across a range of countries to make trade easier.

Q  
R  
S*Bottom-Up  
Diffusion*

- If dominant producers already are shipping to a country with strict standards, they want all standards raised to meet what they are already doing, which has the effect of pushing down competitors.

There are two bottom-up perspectives on diffusion of standards:

- The first is industry, such as particular domestic trade associations within the country of interest. They look at whether they win or lose by conforming to Codex standards.
- The second is government, wherein they look to the Codex to see what is important and then act accordingly.

*Regional  
Initiatives*

A fourth perspective on diffusion can be found in regional integration initiatives.

- Governments in places like Argentina see standard setting in the context of regional constraints under Mercosur and the Free Trade Association of the Americas (FTAA).
- Variation in national adoption of Codex standards depends on the degree to which countries are integrated with regional initiatives.

*International  
Standards*

By the mid-1980s, the CAC wanted overall international standards for food additives because the setting of standards had grown out of sync with major countries.

- Codex initiated the development of a General Standard for Food Additives (GSFA).
- There were many differences to be resolved, and the United States and Europe had different points of view than the rest of the world.
  - There were conflicts over the source of data.
  - Debates went on about whether the standards should include a list of foods where no additives are permitted, such as baby foods.
  - They also debated the technological need or other justification for using an additive.

NOTE: On the issues of justification and source of data, European countries prevailed in their more restrictive views. The list of foods that cannot have additives was adopted but hidden among other lists to limit its use.

*Codex versus  
Domestic  
Standards*

Does the Codex food additive standard affect domestic standards?

- In poor countries, like the Dominican Republic, they have fully harmonized with Codex.
- In middle-income countries, the difference between the Argentine standard and Codex is striking, with Argentina less stringent—but critically the consumer is not mentioned in the Argentine standard.

*The Dominican  
Republic*

Four possible reasons explain why the Dominican Republic adopted the Codex standards:

- Trade associations and producers, who heavily influence the writing of the standards, do not appear to influence whether they are adopted and were not involved in the Dominican decision.
- If domestic business interests are the reason, they should be active in promoting Codex, but it is the countries to whom they export that set the standards.
- The government in the Dominican Republic is also behind the use of the Codex standards.
- The regional integration initiatives of the FTAA and Mercosur directly affect food additive standards.

*Conclusion*

There are three main issues surrounding food additive standards:

- When a country participates in and perceives as important a regional integration initiative that upholds Codex standards, and when there is little prior regulatory history, international standards do influence policies.
- The regional initiatives can be viewed as a part of a policy transfer process, and depending on the degree to which regional initiatives take decisions apart from member states, these can be either horizontal or top-down forces for diffusion.
- Regulatory capitalism in the form of Codex standards is shaped by powerful countries—the role of politics and power in forming highly technical standards often goes unnoticed.



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