ESSAYS IN REGULATION

The political economy of markets

George Yarrow

NS 5.1 2015

REGULATORY POLICY INSTITUTE

Essays in Regulation, New Series

Published by the Regulatory Policy Institute
300 Banbury Road, Oxford OX2 3ED, UK
www.rpieurope.org

First published April 2015

Summary of some of the main points

The word market is widely used in contemporary economic and political discourse, but usually without any clear sense of what it means or is meant to refer to. In a literal sense, people do not know what they are talking about. The first part of the essay therefore examines the question: what is a market?

The answer is that a market is an economic institution, i.e. a set/system of rules that structures, regulates or governs a particular set of activities involving exchange of goods and services. It encompasses both the system of rules and the activities governed by them and it serves a specific, particular purpose or function, which is to reduce the costs of exchange transactions.

The relevant rules are both formal (laws and regulations) and informal (norms, conventions, customs, habits) and, considered as a whole, they are necessarily co-determined by a range of different economic agents. The informal parts of the set of rules are referred to as the market culture.

There is an inherent duality to the institution: the rules are shared by participants – they are a collective 'good' – but their purpose is to facilitate individual action. They tend to work better when this dualism is recognised by participants and is embedded in the market culture. In general it is wrong to characterise markets simply as domains of individualistic behaviour and to think of regulation as something that is extraneous to markets.

Markets and organisations are alternative ways of determining the allocation of economic resources, but they have different specific purposes and tend to be associated with different cultures. Organisations are generally characterised by hierarchical relationships, based on authority, and are broadly restrictive in terms of the scope they allow for individual action and initiative; markets are non-hierarchical and their *raison d'être* is expansion of the scope for autonomous initiative and action (by individuals and organisations).

There can be competition among markets, i.e. competition among institutions, and this has played a major role in the development of commercial societies. However, in a number of contexts such competition is relatively weak and control over, or a significant ability to influence, sub-sets of market rules, particularly formal rules, is a source of market power. It can be used to 'tilt' the outcomes of transactional processes so as to favour some or other 'partial interest'.

When this happens markets can be said to have been *re-purposed*: they are made to serve purposes other than reducing the costs of exchange transactions, tending to make them less effective, not least via the adaptive changes in market cultures that are induced. This phenomenon, which reflects the importation of an aspect of organisational/bureaucratic culture into market governance, is widespread and poses a major challenge in the conduct of economic policy.

The tendency can potentially be mitigated if public lawmakers and regulators: accept that markets exist to serve a specific purpose (reducing the cost of exchange transactions); recognise that market rules are co-determined and that public actions can be expected to have effects on the informal parts of the rule set (i.e. the market culture); recognise the weaknesses of monopolistic, policymaking processes and forebear from exploiting their market power beyond the limits implied by these various considerations.

Re-purposing of markets can be regarded as a form of market abuse in that it is a source of economic harm. Perhaps the most important pathway to harm is by way of the creation of institutional instability and disorder in circumstances where the policy approach can be characterised by *capricious meddling.*

Capricious meddling occurs when markets are re-purposed to achieve or 'deliver' specific end outcomes in transactional processes. As market conditions change, measures taken in an earlier period to achieve the targeted outcomes no longer serve their purpose and market rules are changed to reflect the new conditions. Market rules, i.e. the institutions themselves, are treated as control variables and become potentially subject to constant change.

This may not be a major problem if the consequent rule-change is *contingently predictable*, i.e. knowing of the changed circumstances, market participants can reasonably anticipate the likely adjustments, but this condition is not frequently satisfied. Political priorities are notoriously fickle and contingent predictability is difficult to achieve. Important aspects of the market rules therefore cease to function as rules, since they lack the necessary stability. Markets as institutions are thereby undermined and their effectiveness in serving their primary purpose is eroded.

In concluding comments, a clearer separation is recommended between policy approaches/cultures appropriate for market governance and for management of the organisational tasks of government.

An Annex provides a *tour d'horizon* of the commercial history of England, aimed at filling out some of the more abstract arguments.

George Yarrow[1]

The political economy of markets[2]

Introduction

Markets are a familiar feature of our commercial culture: we engage in market transactions on a frequent and recurring basis. Given this, it is unsurprising to find that those who rely on markets have views about their workings and that such views translate into associated political opinions. These views and opinions can differ quite radically: at one end of the spectrum we find people who speak of the 'magic of marketplace' or the 'miracle of the market'. For them there is scarcely a problem for which 'the market' is not a solution or a source of solutions. At the other end of the spectrum there are those who see markets as malign forces, enriching the few, impoverishing the many and creating threats, instabilities and problems that incessantly disturb and undermine settled ways of life.

Between these end points lies a range of opinion characterised by differing perceptions and assessments of the balance between opportunities and threats associated with markets. For example a common, politically centrist position is that markets have a capacity to produce powerful economic and social effects that must be controlled and/or guided in the name of the public good. On this basis the aim of public policy is to preserve the opportunities for better economic performance afforded by markets whilst limiting the harms that they might cause. Differing political perspectives within this centrist range tend to be associated with judgments about how much control/guidance is appropriate.

Current public discourse on these matters is also characterised by the frequency of statements to the effect that this or that market has 'failed' in some way or other, or that it is 'broken', and by the fact that such statements emanate from a rather broad spectrum of political opinion. Such sentiments are not usually accompanied by a call for the abolition of the relevant market, although there are exceptions to this. Rather there is a call for the market to be 'fixed', using terminology that fits naturally with the notion of 'brokenness' in ordinary language.

The call may be directed at, or be instigated by, politicians who are cast or who cast themselves as suppliers of fixing services. Where markets fall within the jurisdiction of a specialist regulatory agency operating with delegated powers the same tendencies tend to be manifested at the agency level. In each case, when 'retailed' or advertised by their providers these offers of fixing services are typically not subject to the sorts of legal constraints imposed on commercial retailers by rules directed at preventing misleading advertising, fraud, unacceptable trading standards and the like. In consequence, unfounded claims abound.

---

[1] Chair, Regulatory Policy Institute, Oxford, UK.

[2] This paper is based on a Zeeman Lecture given at Merton College, Oxford University on 9 September 2014 and some of the informality of that occasion is reflected in the text, particularly in the Annex.

Whilst there is some variation in the scope and intensity of claims about brokenness and about the efficacies of the regulatory fixes (or retail offers) that are put forward, most mainstream political parties seem nowadays to operate with similar mind-sets within this particular language game. There is a common 'narrative of failure' that justifies a conclusion that something must be done to fix matters and that identifies the politician or regulator as the someone who will do the necessary something.

I will come back to this narrative a little later, but will first take a step or two backwards. My starting point is a curious and remarkable feature of the contemporary discourse: in all this talk about markets, about their effects/implications and about what is to be done, there is generally no pause for reflection on what a market actually is. The word is left undefined. In a literal sense, people do not know what they are talking about. Although it might be considered a rather old fashioned view in a postmodernist political culture, I cannot but think that this is a rather serious defect.

I will therefore begin by considering the question *what is a market?*

Defining markets

Given the widespread use of the term 'market' in economics it might be expected that this discipline would be a natural place to look for a clear definition of what a market is. However, whilst examination of the index of a microeconomics textbook is likely to yield references to sections of the text dealing with notions of market power, market clearing, market failure and the like, there will usually be little or nothing to find about the nature of 'the market' or 'markets' as such. The nearest we get to a formal *definition* of a market in mainstream, university-taught courses is to be found in the area competition economics and competition law. Here a product market is defined as a set of interchangeable or highly substitutable goods or services.

This unfortunately does not get us very far. Consider, for example, the following thought experiment. Go to a large supermarket, collect together a set of laundry detergents from the shelves, stand them together and say to fellow shoppers "that is a market". The responses would likely be interesting, but it is not to be expected that they will approximate "that is someone who knows about markets".

Historians and sociologists have generally done rather better in defining the term, although the fact that their interests tend to be more remote from economic policymaking tends to colour the emphases. It is therefore fortunate that the economics cupboard is not entirely bare. Ronald Coase, a founding father of modern institutional economics, has defined markets as follows:

> *Markets are institutions that exist to facilitate exchange, that is they exist in order to reduce the cost of carrying out exchange transactions.*[3]

[3] R. Coase, *The Firm, the Market and the Law*, University of Chicago Press, 1988.

It is obvious really, although the notion that the market is an *institution* – rather than, say, a place or a set of transactions of a particular type – is not one that leaps from the pages of most economic scribblings. Whilst Coase's definition leaves scope for elaboration and development, it is more than sufficient to get things started.

What I want to argue is that systematically looking at markets in this way – as economic institutions with a specific purpose or function (facilitating exchange by lowering the cost of exchange transactions) – can have profound implications for the way we view things from a public policy perspective and that it is the two words *institutions* and *specific* that are responsible for this.

Consider, for example, the questions:

- How can an economic *institution* that serves to reduce a particular category of economic costs (costs of exchange) have magical or miraculous properties?

- Why should such a widely adopted *institutional structure* be expected to have generally malign effects?

- In what circumstances can such an *institution* be said to 'fail' or to be 'broken'?

The third of these questions is clearly much the most substantive and I will return to it later. For the moment, the main point is simply that once we know what we are talking about, the shape of things begins to look different. To the extent that a market is successful in reducing the costs of a certain type of social interaction (exchange), we obviously need to know a lot more about the nature of the relevant interactions and their wider social/institutional context before it is possible to grapple with questions about economic effects.

To begin exploration of the implications of viewing markets as institutions, consider the fact that, whilst markets are central to modern microeconomics, they are a spectral presence in the textbooks. They lurk conspicuously (the term 'market' is repeatedly used), but they appear resistant to examination. Why is that?

The answer is easily discovered from the definition. If a market is an economic institution whose function or purpose is to reduce the costs exchange transactions, markets will only exist if there are transactions costs that can be reduced. Most microeconomics teaching is, however, typically founded on models that *assume that transactions costs are zero*, an assumption that is made to render the mathematics more tractable. Unfortunately mathematical tractability comes at a price. What is being analysed is a hypothetical, imaginary world in which markets (as just defined) wouldn't actually exist: they serve no function or purpose in such a world.

Abstract theorising about a world in which the costs of exchange transactions are zero is in and of itself a relatively harmless intellectual activity (except perhaps for the pain it inflicts students) and can usefully function as an aid to systematic thinking, but it should forfeit any claims to provide a basis for assessing market performance in our own world. However, Wittgenstein's advice "Whereof one cannot speak thereof one must be silent" has not generally been heeded: instead voices have been loud in speaking of 'market failure' and generations of economics students have been presented with anatomies of such 'failures' derived from models and theories whose assumptions imply that markets have no function to perform.

The consequences of this modern intellectual failure – and here the word failure is entirely appropriate – have not been favourable for the conduct of public policy, but I do not think that the failure can itself be said to be the root cause of most of the observed weaknesses in economic assessments of public policies toward markets: many of these weaknesses were prominent in periods before the concept of 'market failure' entered into economic discourse.[4] Thus what Adam Smith called *partial interests*, i.e. particular groups or individuals who strive to influence *public* policy in ways that further their own, *narrower* objectives, have always had a proclivity to make use of self-serving over-abstraction in their rhetoric.[5] Arguably modern market failure doctrine is just one of many potential ways of constructing the misleading counterfactuals that usually underpin the self-serving rhetoric. Again, I will come back to this point later, but there is more groundwork to do before then.

Markets and organisations

Exchange transactions are not of course the only form of economic interactions, large numbers of which take place in other institutional settings such as households and social networks. In the current context the most relevant of the alternative, institutional structures governing economic interactions is the organisation. The daily business of work in an organisation involves economic interchanges that, whilst they may influenced by general notions of reciprocity, are not reducible to the specific, interaction-by-interaction *quid pro quos* that characterise market exchange.

As Coase argued in his first major paper[6] markets and organisations can be viewed as alternative forms of economic organisation. Important differences between the two include:

- Whilst each may be said to serve the purpose of reducing transactions costs (i.e. the costs associated with economic interactions), and whilst the two institutional forms can be directly compared in how well they succeed in this, for markets it is their *only*, or at least their heavily predominant, purpose or function. That is not the case for organisations. A large business enterprise, for example, might want to conduct its internal affairs (its intra-organisational transactions/interactions) in an efficient way, but it does so largely as a means to other ends. The same can be said of other types of organisation such as public bureaucracies.

[4] This can be provisionally dated as the publication of F.M. Bator, "The Anatomy of Market Failure", *Quarterly Journal of Economics*, 1958.

[5] For further discussion see G. Yarrow, "Dysfunctions in economic policymaking, Part 1: Simple stories, complex systems and corrupted economics", *Essays in Regulation,* Regulatory Policy Institute, 2014, and "Heuristics and biases in regulatory decision making", *Notes and Letters on Regulation*, Regulatory Policy Institute, July 2014.

[6] R. Coase, "The Nature of the Firm, *Economica*, 1937.

- Organisations typically depend heavily upon various types of authority relationship in structuring economic interactions. Williamson, for example, characterises them as hierarchies.[7] Markets do not have this feature: sellers have no authority over buyers and *vice versa*, although there can of course be power imbalances between the parties to transactions. Indeed political economy has traditionally been much concerned with the distinction between monopoly or monopsony (where one party enjoys a substantially higher level of economic power than its counterparties) and competition (where the balance of power, at least in relation to the relevant transactions, is much more equal). As a shorthand expression I will refer to market exchanges as 'horizontal' interactions or transactions and to social/economic exchanges characterised by the exercise of authority in an organisation as 'vertical' interactions or transactions.[8]

These distinctions are of profound importance for the conduct of public policy since a significant number of policy choices involve shifts in the balance between 'vertical' and 'horizontal' interactions in economic life. Moreover, the *cultural*[9] implications and requirements of the alternatives differ, posing challenges for public policy systems that have responsibilities for the governance of both.

What is an institution?

If markets are defined as institutions, the next step in clearing the ground is to consider the follow-up question: what is an institution? The concept is widely used in the social sciences and, although precise definitions vary, the following will serve for current purposes:

> *Institutions are systems of established and prevalent social rules that structure, govern or regulate social interactions.*[10]

The word *established* signifies a certain givenness of the rules to each individual whilst the word *prevalent* indicates that the rules are applicable to a relatively wide group, not just to an individual or small group such as a household or family. The more difficult word *rule* is here to be construed broadly: it includes norms of behaviour, conventions, customary practices, shared patterns of behaviour and habits, as well as formal laws and regulations. Roughly it is a statement, instruction or guide as to how to behave in particular circumstances, i.e. a statement that in set of circumstances **S** (the 'state of the world') conduct should fall within a set of possible behaviours **C**. The set **C** may contain only a single element, as when the rule prescribes a specific action, or it may contain multiple possibilities, as when the rule prohibits or excludes some actions (e.g. don't mislead) but leaves open a range of acceptable behaviours that comply with the prohibition.

---

[7] O.E. Williamson, *Markets and Hierarchies*, Free Press, 1975.

[8] Far from all intra-organisational transactions are vertical in this sense: large numbers of 'among-equals' interactions plainly occur and these may be of great significance for organisational performance. The point is simply that the existence of authority is a central and fundamental feature of the organisational structure – which governs and affects other interactions – whereas this is not the case in market exchange.

[9] See below for an explanation of the meaning of this term in the current context.

[10] See G.M. Hodgson, "What are Institutions?", *Journal of Economic Issues*, March 2006.

The general effect of institutions is to create stable expectations about the behaviour of others, *"enabling ordered thought and actions by promoting form and consistency in human activities"*.[11] Institutions can therefore be said to govern (in the sense of influencing, controlling or regulating) social actions and behaviours. To serve this purpose or function rules must have a degree of durability: if they themselves are unstable or unpredictable they will not be capable of sustaining stable expectations.

In the more technical language of economics and mathematics the rules that constitute institutions might be referred to as state variables or as structural features of the economic and social landscape, which is not to say that they are unchanging over time. Institutions evolve or are purposefully modified, but generally at a relatively sedate pace relative to the frequencies of the activities that they govern, consistent with the promotion of form and consistency in social actions or behaviours associated with those activities.

Refining Coase's definition then, a market can be defined as *a shared system of rules whose purpose or function is to facilitate exchange by reducing the costs of exchange, i.e. to structure/govern/regulate relevant social interactions in ways that reduce the costs of exchange.*

Seeing things in this light leads immediately to a perspective at variance with a common (implicit) supposition in much current policy discussion: since they structure or govern a certain type of economic/social interaction (exchange) *markets are themselves inherently regulatory in nature*.

In contrast to this perspective, contemporary discourse tends to see markets and regulation as different things, as for example when regulation is viewed as a means of correcting market failures. On this view, regulation is something of a *deus ex machina* and, when considering regulatory action, there is a familiar trope that practical policymaking should seek to strike a balance between market failure and regulatory failure. The language here is strongly suggestive of a categorical distinction between markets and regulation. The discussion above indicates that there is not: markets themselves regulate certain types of human actions and behaviours that are connected to the exchange of goods and services.

Once recognised, the proposition that markets are regulatory in nature makes it much easier to make sense of the structure of economic organisation. Whether the market of interest is a medieval town or village market or a contemporary commodity exchange, it is immediately obvious in these cases that the institutional set up serves to govern economic actions and behaviours. In the commodity exchange case, for example, what is observed are systems of rules governing things like who can participate in trading, the times at which transactions can be made, the responsibilities of the parties, the terms of financial settlement, the settlement of disputes, and the likely consequences of infringing the rules. Not entirely dissimilar lists of market rules could be found in medieval towns and villages, although the regulation of weights

[11] Hodgson, *ibid.*

and measures would be a much more salient feature of the institutional arrangements in the latter context.

The duality of markets: entanglement of the individual and the social

Markets then are systems of rules that govern/structure/regulate activities to do with exchanges of goods and services, which are activities undertaken by *individual* economic agents (buyers and sellers).[12] It is on these individualistic activities that much of the attention in economics and business studies tends to be focused. More specifically, the interest tends to lie in the sequences of actions associated with exchange, i.e. in the *processes* of competition, price determination, and so on, and in their likely consequences (the 'outcomes'). It is, I think, this emphasis that gives rise to the general association of markets with individualism.

Indeed, to the extent that there is any shared perception, however clouded, of what a market is it probably rests on association of the word with the process of buying and selling, and in one sense the association is well founded. The exchange processes are what the market rules govern and the scope of what it is that is governed will determine the extent or domain of a particular market, i.e. of a particular system of rules.

If, however, we take a wider perspective, what then comes into view is a *shared* social structure governing and promoting an *individualistic process*, i.e. governing and promoting sequences of activities (buying and selling) in which individual economic agents make their own decisions under no instruction from anyone else. Schematically, what we observe is:

A shared/collective, stable (but mutable) system of rules

governing conduct in a way that serves to facilitate exchange transactions between

individual economic agents

[12] Businesses can be regarded as individual economic agents for current purposes although they are at the same time institutions in their own right: they are structured or governed by internal systems of rules that affect their actions and behaviours. The difference between the two different types of institutions (firms or organisations and markets) lies in the scope and purpose of the relevant system of rules. Specifically, it is not the purpose of businesses to reduce the costs of exchange transactions, although they make seek to do so in pursuit of other goals of their own goals (e.g. profit).

Because of the close linkages between the system of rules itself and what it is that it governs, no great difficulty appears to be caused by the using the word market in a way that encompasses the relevant transactional processes. Coase's definition can be broadened to include both the rules and the activities that are governed by the rules, i.e. to refer to the above schema as a whole, and this is the definition that I will now adopt. What is much more problematic is a failure to recognise that the buying and selling is only *part* of the picture, that the transactional processes are structured by a system of rules, and that the institutional arrangements play a key role in determining outcomes. This is to neglect the collective/social aspects of markets.

An undue focus on the transactional processes also risks neglect of an important, ancillary point: participation in rule making and enforcement/compliance amounts to participation in the market itself. This is somewhat different form of market participation from engagement in the relevant types of exchange transactions, although there is in reality often no hard and fast distinction between the two: for example, systematic violation of market rules (which encompass social norms as well as formal laws and regulations) by parties engaged in exchange transactions can be expected to undermine the integrity and effectiveness of those rules. Put another way, over time transactional behaviour itself has effects on at least some sub-sets of the market rules.

To the extent that markets serve their primary purpose or function of reducing costs of exchange they expand the range of possibilities for individual action. The horizontal nature of the exchange transactions also reduces the domain of 'authority' in determining economic outcomes. Markets therefore rightly occupy an important place in classical liberal thinking.

It is also right to think that the development of markets has played a major role in expanding economic output and raising living standards. Perhaps the chief mechanism by which this has come about is set out in Chapter 1 of Book 1 of the first great work of political economy, *The Wealth of Nations*. Markets facilitate the division of labour, which raises productivity and is conducive to innovation. As Smith put it, the division of labour is limited by the extent of the market: the smaller the number of buyers and sellers who can trade with each other at non-prohibitive costs of exchange the less can specialisation in production be pushed without creating undue risks that what the supplier offers will not find buyers or that what buyers seek will not be available from suppliers. An increase in trading opportunities therefore tends to lead to increased productivity and enhanced incentives for innovation (there is more to be gained from finding new and better ways of doing things).

These tendencies – toward the expansion of individual freedom and toward increasing prosperity – are nevertheless properly viewed as by-products of markets, whose primary purpose or function is to reduce the costs of exchange transactions. Moreover they are not the only by-product: markets are also associated with a particular type of socialisation.

Market culture and market governance

Market participation tends to greatly expand the number of social interactions in which any particular individual is engaged. The strength and significance of these interactions varies according to the nature of the goods and services involved, but in general they can be said (a) to be 'weaker' than, say, the interactions with close friends and family or with close colleagues in an organisation, but (b) to involve many more 'others' than is the case for those types of stronger interaction. Put another way, an individual's social network is expanded, but, inevitably in view of the limited resources (of time and cognitive capacity) available for social interaction, less attention is afforded to each of the members of the wider network.

There are, of course, contextual constraints on the extent to which market rules are able reduce transactions costs, which are also affected by factors such as ease of communication and the level of transport costs. The scope and extent of markets can therefore be expected to change over time in response to changes in these other variables.

Good faith participation in a market means acceptance of the shared system of rules that define the market and involves a voluntary decision to engage with a shared social structure. More than that, it generally provides individual economic agents with roles in the determination of the relevant system of rules. Recall again that the word 'rule' as it is being used here encompasses norms of behaviour and conventions as well as legal rules and regulations. Thus, even if market participants have no influence on the sub-set of the system of rules comprising legal statutes and formal regulations, they generally have influence over shared norms of behaviour and conventions. A loose analogy to the processes involved is the way in which the speakers of a language influence the evolution of the language.

To fill out the picture further it can be noted that the system of rules may contain, as one of its sub-sets and depending upon the types of goods and services involved, rules governing the processes of future rule-change. This applies specifically to the formal parts of the system of rules since the more informal aspects – the conventions, customary procedures, norms, habits and the like – are more likely to be governed by evolutionary processes of individualistic or sub-group experimentation and selection. There is, therefore, generally a two-level, formal governance structure to be considered:

- Governance of the transactional processes themselves.
- Governance of the relevant, formal parts of the market rule-book that structures the process of exchange.

Markets as institutions therefore contribute to forms of socialisation via both the processes that they govern (the exchange interactions among the participants) and the development of shared systems of rules (the institutional aspects). It is, moreover, a form of socialisation that simultaneously emphasises the importance and significance both of the system of rules and of the opportunities for individual action that the institution creates.

The emphasis on individual action in this combination of features is perhaps what differentiates market cultures from organisational cultures. Many of the above remarks would apply equally well to organisations, which comprise systems of informal as well as formal rules, but organisational cultures develop in a context in which there are much stricter bounds on the scope for individual action. For organisations individual action is sub-ordinate to the specific goals/purposes of the relevant operation, whereas for markets expansion of the possibilities for individual action is intimately linked to the institutional purpose or function.

A shared understanding of the duality of markets, encompassing both the systems of rules and the conduct that they govern, is facilitated by a characteristic of markets emphasised earlier in this paper: these are specialised institutions with a specific purpose or function, to reduce the costs of exchange. Buying and selling are important, everyday activities and the system of rules has direct and immediate relevance to how well those activities go.

The direct linkage between the institutional set up to 'how well things go' in quotidian economic activities arguably also contributes to a form of socialisation that views the relevant system of rules in a relatively instrumental way. The system may be a given to the individual at a particular time, but it is not God-given and immutable. If it is perceived that costs of exchange are higher than they might be, it is natural to look at the market rule-book and its enforcement to see if and how things might be improved. The particular form of socialisation associated with market participation might therefore be said to be conducive to a form of institutional inventiveness.[13]

There is clearly a tension here between inventiveness and the requirement that institutions function in ways that promote co-ordination of economic activity by enabling the development of stable expectations about the behaviour of others. Too much chopping and changing in the rules can impair such development and I will return to this critically important point later. For the moment it is sufficient to identify the factor that appears to be the most important in resolving the tension in a relatively favourable way, the hinge on which things turn: it is the *specialisation* in the institutional purpose or function.

Provided that it can be maintained, the *shared* purpose of reducing the costs of exchange serves as a background, stabilising factor. Market rules may change over time, but provided that rule-change is guided by this specialised purpose the changes will have a degree of 'contingent predictability' about them. By this I mean that, if there is a change in circumstances – for example, because technological developments open up the possibility of lower cost methods of engaging in transactions – reasonable inferences can be made about the likely future development of market rules: there is a degree of predictability as to how they will evolve in response. The change in circumstances may have been completely unpredictable, but once observed the subsequent development of market rules will not be.[14]

[13] The implicit comparison at this point is with institutions with less specific purposes, not with organisations.

[14] In regulatory policy this is often what is meant by the term *regulatory certainty*. However, this other way of putting things has come to have multiple and frequently vague usages and the more precise expression *contingent predictability* is to be preferred.

Inter-market competition

Since the system of rules is shared by and influenced by those who choose to participate in the structured system of exchange, there is potentially a political dimension to all this: politics is, after all, concerned with governance issues. I say potentially because there is an important line of reasoning to the effect that politics can be avoided by competition among markets themselves, i.e. by competition among institutions. Although I do not think that this argument can be sustained in its entirety, it nevertheless has considerable force in many contexts and it has high salience when assessing the scope and nature of the collective choice aspects of markets.

The line of reasoning can be motivated by noting two facts. First, in many circumstances, would-be buyers and sellers can, for particular types of transactions, choose between participation in different markets. For example it may be possible to buy and sell on different commodity exchanges, to shop in different high-streets, or to buy/sell on the high-street or on-line. This is not a new phenomenon: in the Annex to this paper I will give an example, just one of a multitude that could be given, of choices between trading in markets in Newcastle and North Shields in the late thirteenth century.

Second, many markets are proprietorial in nature: they are operated and run on a for-profit basis. In these cases the proprietor may provide physical infrastructure required for trading – for example an online platform or market stalls – and be responsible for the market rule-book, including at least some aspects of its enforcement.

It is therefore possible to envisage a set of self-organising markets that compete with one another: market proprietors offer their services and seek to attract buyers and sellers from whom, in various ways, payments are extracted in return for rights of participation. Successful proprietors will attract business from less successful proprietors, some of the latter will close down their activities, and new proprietors with new ideas will emerge, motivated by the prospect of financial returns. In short, a market society can potentially emerge and be sustained via a process of natural selection. Modern economics has even developed a rudimentary, theoretical framework for analysing such a process, albeit using a misleading terminology that refers to 'platforms' and to 'two-sided' markets.[15]

The difficulties emerge when the arguments are taken too far and are used as a basis for a conclusion that politics and collective choice is completely redundant in all this. Whilst inter-market competition both exists and is an important fact of economic life, the degree of competition among markets clearly varies from context to context, and where competition is weak the normal selection processes of competition can be expected to operate with relatively long time lags. Since the economic environment is constantly changing this can potentially

[15] See, for example, J-C Rochet and J. Tirole, "Platform competition in two-sided markets", December 2002.

lead to an economic system that is in a permanent state of chronic inefficiency, with systems of rules are always poorly adapted to the circumstance of the time.

This is not the place for an extended discussion of inter-market competition, but one or two points will illustrate some of the underlying reasons for the observed variations in its strength. The most important perhaps is that adaptations of rule-books (i.e. the competitive responses in a situation of inter-market competition) take time. The temporal lags may partly be intentional, as when legal and regulatory changes are subject to process constraints that are introduced in order to sustain the temporal stability in rules that is required to establish stable expectations about the behaviour of others. They may also be unintentional: social norms, conventions, shared understandings and habits are often slow to develop and not readily abandoned as times change, a phenomenon that may itself be an evolutionary adaptation driven by the value of stability and order in social life.

In practice much will depend upon the nature of the relevant market. Many markets will govern transactional behaviours that are relatively similar to one another and the rule-sets may then be similar, with many common elements. In other cases there may be more differentiation in the institutional arrangements, in which case new participants, whether buyers or sellers, may face considerable costs when initially engaging with a new market. Investments of time and effort may be required to learn about the relevant system of rules, including things like the degree of compliance of market participants with the rules (which affects trust and confidence in counter-parties and hence affects the anticipated costs of exchange) and the redress that can be expected to be available in the event that transactions go wrong.

In economic terminology these investments can be interpreted as forms of entry costs or of (market) switching costs, and in general their existence can[16] serve to weaken the effectiveness of competitive pressures.

Inter-market competition may also be subdued on account of the preference of buyers and sellers for markets with larger numbers of participants because they offer more mutually beneficial trading opportunities. This makes it more difficult for new markets to become established, expand and survive, such that the process of incremental improvement is impaired and new institutional forms only emerge as a powerful source of competition when they are associated with major, disruptive changes originating from other sources, for example a major change in trading technologies or transport costs.

[16] It can be noted in passing that this effect is not inevitable: the 'stickiness' of a buyer/participant increases the value of his/her business to a seller/proprietor – the commercial relationship is likely to endure and to provide a source of revenues over an extended period – which may serve to stimulate extra competitive effort to acquire the buyer's/participant's business. The prize may be more difficult to win, but it is bigger. The major chilling effects on competition therefore are less to do with 'stickiness' *per se* than with possible asymmetries between the alternatives on offer. More specifically, switching from a market (A) with which a participant is familiar to another (B) with which he/she is not familiar may be more costly than subsequently switching back again, because the value of initial familiarity (with A) is not entirely lost. In that case, other things being equal the value of the participant will be higher to the first proprietor (of A) than to a potential, competing proprietor (of B) and the costs faced by the latter in garnering new participants may be prohibitively high relative to the benefits (because, once attracted to B, the participant is 'less sticky' than before).

In practice then, whilst buyers and sellers can have some degree of choice among markets in which they buy or sell, the degree of substitutability among the alternatives cannot be presumed to be generally high, and in some cases it will be low. In the latter contexts control of, or substantial influence on, a particular system of rules can therefore confer significant power on those who have the capacity to exert it and it is these cases that tend to create a 'politics of markets'.

The politics of markets

This is all to say, then, that markets characterised by the feature that control of or significant influence over the system of rules is a source of market power – a feature that is frequently observed in practice – tend to come with a political dimension. The rules imply the existence of governance issues of one sort or another and these are arenas of contest, not least because the precise details of the institutional structure can have significant implications for the various fractions of the aggregated gains from trade likely to be available to different types or sub-sets of market participant.

Thus at one and the same time it is possible to observe what might in one sense (the normal sense in economic thought) be described as (a) a highly competitive market characterised by large numbers of buyers and sellers that is (b) governed by a *single* system of rules that potentially offers substantial power over the detailed form of the competitive process, and hence over its outcomes, to anyone who can exert control of or significant influence over at least some sub-sets of those rules.

Economists are used to thinking that problems arising from monopoly and from market power more generally can be resolved by establishing transactional processes with large numbers of buyers and sellers such that no one transacting party can significantly influence prices and volumes traded. A corollary is that the route to market power lies in becoming a counterparty in a large fraction of the total volume of transactions, e.g. achieving a high market share. However, this view has developed from prior reasoning that has typically neglected the institutional nature of markets. Once the institutional realities are recognised it is obvious that there is an alternative route to the establishment and exploitation of market power, via the development of influence on rule-books. In my own experience this is the more important of the pathways to economic power in today's world and the history books suggest that it was ever thus.

Given the title of this paper the conclusion here should come as no surprise. From its foundation political economy has been focused on the question of how to make things go better for a public reliant on markets by making better *collective* choices about how transactional processes are governed.   As Winslow has put it: *"Political economy originally meant the management of the body politic with the objective of providing to its members the material means of a good life."*

It is to be noted however that, although political economy's greatest single work, the *Wealth of Nations*, contains a sustained critique of what at the time was considered to be a particularly harmful politics of markets (the mercantile system of Great Britain in the 18th century) it would a misreading of that book to believe that the alternative in contemplation (the counterfactual) was a full and comprehensive de-politicisation of markets. Rather, the counterfactual appears to rest on notions of the policies toward markets that would be adopted by a 'wiser sovereign'. Let me therefore follow this approach by first sketching three, inter-related features or principles that might characterise such policies before turning to the modern analogues of Mercantilism. These principles are:

1. ***Alignment of public policy market governance objectives with the fundamental purpose or function of markets, reduction of the costs of exchange.***

This implies that the policymaker sees his/her own task (in establishing general policy towards markets) in terms of assisting markets to function more effectively in achieving the recognised and accepted common purpose (which is or should be shared by all market participants). Although there may differences of view as to how that is best achieved in a particular context, the objective should be a shared one.

The conduct of competition law and policy in tackling exclusionary practices is perhaps the clearest modern implementation of this principle. Exclusionary practices serve to raise the costs of exchange between buyers and those sellers or potential sellers who might pose a competitive threat to powerful, established businesses, by offering alternatives to buyers.[17] In more general terms, such policy can be characterised as being directed at eliminating or reducing restrictions of trade.[18]

Consistent with the principle, the competition policy approach can be generalised to encompass policy directed at other features of market arrangements that serve to raise transactions costs – for example because the market rules have come to be unduly influenced by one or more 'partial interests' – without giving rise to compensating gains from trade. (The qualification here is an important one because, for example, the introduction of new products and services that are of general benefit may necessarily require higher costs of exchange than established products and services.)

[17] Exclusion can also be practised by powerful buyers.

[18] The standard terminology used nowadays in competition policy, which speaks of *promoting competition*, tends to be unhelpful since competition is not something that is seen by most people as being manifestly beneficial. Empirically, many forms of competition have substantial, *adverse* consequences, the competition between rival factions in conditions of civil war being a case in point. The point about exclusion is that a supplier with market power seeks to raise the *cost of transactions* between willing buyers and some other, rival seller, to its own advantage and to the detriment of the buyer. Framed in this way (one party seeking to increase the costs of transactions between two other parties) it becomes much more obvious why seeking to establish market rules that prevent or inhibit exclusionary practices is likely to be a good thing to do. 'Competition', which at bottom simply means 'rivalry' is too broad a concept – applicable to a wide range of situations with widely differing consequences for parties affected by it – to command much visceral support.

Similarly, standardisation of some parts of market rule-sets may be consistent with the principle, as when it has the effect of rendering it less costly for buyers and sellers to switch between different markets, thereby increasing inter-market competition and establishing sustained pressures for constant improvements in institutional arrangements where these are feasible. In other contexts, however, rule-standardisation can hinder innovative adaptations of institutions to changes in the economic environment. Good public policy will require balances to be struck, but the main point to hold on to is that, in resolving the trade-offs and striking the balances, the relevant criterion for judgment is some measure of the costs of exchange transactions, both now and in the future.

2. ***Recognition of the inter-dependence between formal and informal parts of the system of rules and hence of the fact that market rules, considered in their entirety, are necessarily co-determined.***

Whether the focus is on issues that cut across many markets or on issues that are confined to just one market or a small number of inter-related markets, the methods by which public policy is most usually implemented are focused first on the formal parts of the relevant systems of rules (laws and regulations). These formal rules, however, comprise only a sub-set of the market rules, which also encompass what I have called the informal rules or the market culture. As discussed, market rules can properly be said to be *co-determined* by a larger set of economic agents, not just by a legislative or regulatory authority.

A market can be characterised as *complex, adaptive system*, in which the rules governing the interactions among its participants themselves change over time. Public policy makers should therefore recognise that any changes they themselves introduce can be expected to lead to mutations in the informal rules – driven by a constant search by potential buyers and sellers for lower-cost ways of effecting their exchanges – and that some assessment of the latter possibilities is required when evaluating policy measures. Political economy is not like a game of institutional chess where a prospective move can safely be made on an assumption that everything else, including the rules of the game, will remain the same, and that only the responses of another chess-player are a relevant consideration. Not only can the pieces move themselves, they can also change the rules by which their movements are guided.

Changes in formal rules therefore have both direct and indirect effects on transactions costs: direct effects are defined via a *ceteris paribus* assumption about other elements of the market rules, indirect effects occur via adaptive changes in other parts of the rule-sets. The latter can include adaptations within the market governed by the relevant formal rules (e.g. changes in social norms or habits), adaptations in other, substitute or competing markets (e.g. via developments in a ‘black’ market alternative to a commodity subject to a price control) and adaptations in what can be characterised as off-market trading (i.e. where exchanges take place that are not governed by a prevalent system of rules and which are therefore ‘not institutionalised’).

3. Recognition of the limitations of public decision making processes.

Except where it is completely ineffective, the implementation of public policies toward markets is itself an exercise in the use of market power. Indeed, any role that the state takes in the process of market rule-making is liable to be less constrained than, say, the rule-making of a market proprietor or of a powerful interest group.[19]

Even if a parliament or public authority is conscientiously operating according to Principles 1 and 2, it will therefore still face two difficulties that are inherent in the monopolistic nature of the decision process. First, policymakers will typically have highly limited information about the adaptive system with which they are dealing (monopolistic decision making is generally poor at processing and making use of information for all but fairly basic, routine tasks). Second, because of the weaknesses of the competitive constraints on their own decision making, policymakers will typically have weaker incentives than, say, a market proprietor or other, non-state rule-makers – whose payoffs tend to be more heavily affected by the costs of exchange transactions – to get things right.

A demonstrated propensity to fail to recognise the limitations of (monopolistic) public decision making processes, as for example when politicians or regulators operate on a belief that they have a wide ranging capacity to 'fix' perceived weakness in institutional arrangements, tends to encourage more general expectations that interventions can be induced so as to favour a 'partial interest'. Thus, an advertised, perceived capacity to use market/monopoly power in this way will in and of itself create additional demand for use of that capacity, and this is a phenomenon that appears to be a major feature of current public policymaking: in a nutshell, availability creates demand.

The re-purposing of markets and market abuse

The birth of political economy in the eighteenth century took place in an intellectual environment that can reasonably be said to be one of optimism, but there was also a pessimistic side to some of the thinking associated with a sense of the *fragility* of the institutional structures that were assessed as favourable to economic progress. This sentiment was less to do with a sense of loss from the displacement of old traditions (see further in the Annex), but rather more to do with an appreciation of the vulnerability of effective institutions to factors that could undermine them and replace them with something worse, not better.

The intellectual assaults of early political economists were focused on the main problems of their day – in Britain the prevailing mercantile system – but I think the critiques can be generalised in ways that can help us understand today's threats a little better. I will label the generalised problem the *re-purposing of markets*. By this is meant a systematic tendency to seek to manipulate a form of economic institution that has developed to serve a specific purpose

[19] The public monopoly is not entirely unconstrained, of course. For example there can be jurisdictional competition, a form of inter-market competition associated with migration of transactions from one political jurisdiction to another. There can also be substitution into 'off-market' trading.

so as to use it as an *instrument* to achieve some other, different purpose or purposes. This type of manipulation is, I believe, often an exercise in the *abuse* of market power, i.e. use of market power in a way that causes or can be expected to cause harm.

Such 'market abuse' is not a new phenomenon: the underlying issue is simply the widespread, attempted use of influence over a system of rules so as to induce outcomes that are favourable to a particular *partial interest* in society, in violation of the principles set out above. In relation to the mercantile system the manipulation took the form of politicians legislating for tariffs and restrictions of trade in response to what Smith described as the "clamorous importunity" of merchants, but the same phenomenon could occur when any interest group or any partial body of opinion influences the system of rules (the market) in ways that promote its own, sectional interests.

A similar phenomenon features prominently in the economics of regulation, where the notion of regulatory capture is a major theme. It is, therefore, tempting to refer to 'capture' of the market rules, but that I think would be potentially misleading since the system of rules that defines a market is more than just formal laws and regulation: it also comprises norms, conventions and habits that are often highly resistant to capture. What happens is that some parts/sub-sets of the rules are varied with the intention of 'tilting' the outcomes of market processes toward the outcomes desired by the party or parties with market influence, and the word manipulation appears to be a more appropriate description. Using this terminology, manipulation of sub-sets of market rules is the means by which the re-purposing of markets is achieved.

The suggested use of language ('manipulation' and 'abuse') also fits with the inherent duality of markets. The terms market manipulation and market abuse are currently used to describe harmful and unwanted conduct of participants *in transactional processes*, particularly in contexts involving financial products and services or involving commodities trading, by the exertion of undue influence over price determination. Since the effect can be to raise the costs of exchange transactions generally for those who participate in the market (e.g. by increasing the perceived risks associated with trading), relevant market rules typically discourage such conduct.

Undue influence on or control over a sub-set of market rules has effects analogous to those caused by manipulative, transactional conduct. The aim in both cases is to obtain better outcomes for some or other partial interest and the enduring harmful effects occur by virtue of the increased costs of exchange transactions that result.[20] Thus, the notions of market manipulation and market abuse can be broadened so as to encompass two types (not just one) of behaviour:

- Conduct that harmfully influences the price outcomes of transactional processes for a given set of market rules, and

[20] There will, of course, also be more immediate harm inflicted on those parties directly affected by manipulative conduct.

- Conduct that harmfully influences the rules themselves.

The common factors in each case are: the exercise of power (over prices, over rules), the pursuit of a partial interest, and harmful effects on others by virtue of increased costs of transacting in the relevant market.

Ultimately the harm done by each type of market abuse, direct and indirect, is to other market participants and potential participants. In the second (indirect) case, however, the end result occurs via damage to an economic *institution* and, because of the neglect of the roles of institutions in much of contemporary economics, this type of abuse has tended to receive less systematic attention than the first – a tendency that is likely reinforced by the fact that direct (non-institutional) effects are usually easier to identify and measure, making the task of the analyst more straightforward. Unfortunately, it is probably the case that the effects of institutional damage will often be the greater of the two.

Successful manipulation of market rules tends to change the way in which markets function. An institution whose purpose is to reduce the costs of exchange is altered so that it serves another purpose, e.g. to achieve certain end-outcomes from the transactional processes. This has two main effects:

- The market itself tends to function less effectively. Constraints are placed on the rule-set so that it no longer evolves in ways that best serve its principal purpose (reducing the costs of exchange transactions). The by-product of lower transactions costs, greater gains from trade, will also suffer in consequence and this is the basis not only of the classical critique of restrictions of trade but also of excessive regulation that has the unwanted effect of significantly increasing the costs of trading.

- Institutional instabilities will likely be created.

The second point here is one that doesn't feature prominently in economics literature and it therefore merits some elaboration.

Institutional instability and disorder

Markets structure/govern/regulate exchange processes that, in their very nature, lead to unpredictable outcomes. Not only are the information sets of the buyers and sellers unknowable to an observer, the relevant processes are themselves discovery processes: they are constantly generating new information and knowledge. New information is *definitionally* unpredictable (if it is predicable it can't be new information or knowledge, it must already be known in some sense).

We can conceptualise this situation in terms of a mapping from a rule set **R** (partly formal laws and regulations, partly informal norms and conventions) and a set of actions ('conduct') of buyers and sellers **C** in a relevant context or state of nature described by set $\boldsymbol{S}$ (usually known in small part and unknown in large part) to a set of unpredictable end outcomes $\boldsymbol{E}$ (italics here denote uncertain/stochastic variables).

$$\mathrm{F}\colon\ (\mathbf{R}, \mathbf{C}, \boldsymbol{S}) \rightarrow \boldsymbol{E}$$

Suppose a party with significant influence or control over a sub-set of the market rules **R** – for example a politician or regulator – seeks to use that market power to achieve specific desired outcomes. In this formal summary of the situation, elements of the relevant sub-set of the market rules become control variables that are used to guide outcomes. In the (hypothetical) limiting case in which the aim is to determine outcomes precisely and in which this objective is fully achieved, what is observed is a transposition in the above mapping such that:

$$\mathrm{f}\colon\ (\mathbf{E}, \mathbf{C}, \boldsymbol{S}) \rightarrow \boldsymbol{R}$$

That is, the rules become uncertain because they are constantly adjusted to achieve the targeted outcomes in a changing, uncertain context. As emphasised above, it is always only a sub-set of the rules that will be vulnerable to manipulation, but the uncertainty transferred into that sub-set of control variables can also be expected to spread to the more informal parts of the rules, or the market culture, since these will tend to adapt in response to changes in formal rules. The result is a tendency to institutional instability or disorder, which, given the role that institutions such as markets play in co-ordinating economic activities, has the potential to be highly dysfunctional for economic performance. Market rules that are constantly changing risk becoming not rules at all. They lack durability and tend to fail in fulfilling their role of creating stable expectations about the behaviour of others.

A number of factors affect the magnitudes of the resulting effects, including:

- The transfer of uncertainty from outcomes to rules can be expected to be greater the wider the range and the more precise are the targeted outcomes. Where for example the 'outcomes objective' is specified in relatively broad terms there is more chance that circumstances will be such that actual outcomes are deemed satisfactory in the sense that no further rule change is required. Precise targets, on the other hand, are likely to call forth constant re-adjustments or constant meddling.

- Relatively frequent rule change will tend to be less harmful if the pattern of adjustment itself exhibits some stability. Thus, if it is known that parts of the system of rules will be adjusted to achieve outcomes in a certain range, it will be possible to make inferences about how rules will likely evolve in a given set of circumstances. That is, market participants could then develop a shared expectation of how rules will change *contingent* of the eventuation of particular end-outcomes. That is, the rule-change process can become *contingently predictable* and therefore, in effect, become part of the institution itself.

- Where the re-purposing of markets emanates from politicians or more opportunistic partial interests, the desired end outcomes tend themselves be volatile. Political priorities in particular are notoriously unstable, shifting with events. Interest group A

> may be favoured today, interest group B tomorrow. Indeed interest group B might be favoured tomorrow precisely because interest group A has been favoured today, either to balance things up or simply in the constant search for votes and favours. The rules will be adjusted in response to these changes in priorities. In energy, for example, it might be a case of more weight to climate change issues today, more weight to security of supply tomorrow, more weight to affordability the next day, and maybe (for example in the event of a nuclear accident) more weight to safety considerations the day after that. The trigger for change may be something as simple and unremarkable as a change in Minister. Thus, a new Minister arriving at his/her desk will be asked by civil servants for a clarification of his/her priorities (so that they can get about their tasks) and the priorities may easily differ from those of his/her predecessor for no particularly good reason.[21]

Contemporary politics therefore tends to introduce a double-dose of rule-uncertainty/ institutional instability into the economic structure, first by setting great store on identifying specific targets that the politician wants to see 'delivered' and second by a fickle attachment to the specific targets identified at any one time. The best description that I can come up with for this conduct is *capricious meddling* and, by virtue of the economic harm that it can cause, it can be properly characterised as a form of *abuse of power over markets*.

In practical terms the resulting instability is prone to reveal itself in a decline in trust and confidence in market institutions and their governance. This tendency alone is sufficient to give rise to substantial impairment in the ability of markets to serve their primary function of reducing the costs of exchange. Lower levels of trust and confidence tend to give rise to higher costs of exchange and hence to lower levels of market participation, lower traded volumes and higher prices.

More specifically, the investment required of individual market participants in learning about market rules is higher the more frequently the rules are changed and the more arbitrary and less intelligible the changes are (i.e. the less *contingently predictable* they are). This again serves to increase the costs of exchange and one of the most neglected facts in contemporary discourse about the burden of regulation and its effects on economic performance is that *changes* in the rules, particularly unpredictable changes, can impose much greater costs on market participants than lengthy, but relatively stable, rule books.

Abuse of market power via capricious meddling can also serve to undermine confidence and trust in the political processes from which it emanates. Democratic politicians of all people should be able to grasp the nature of the underlying problem. The rule-book of democracy provides for elections in which prospective outcomes may well be to the disliking of an incumbent political party or faction. The rules could potentially be changed to make a loss of power less likely, but the extent to which this can be done is highly limited if the legitimacy of the democratic rule-book itself is not to be seriously undermined.

[21] The discretion that is available here is simply a manifestation of the underlying market power.

Acceptance that the results of electoral processes may not always turn out to be liking of those temporarily entrusted with governance responsibilities, coupled with abstention from trying to fix this perceived weakness in circumstances other than where there is a manifest and clearly substantiated public interest case for so doing, is one of the cornerstones of democratic processes themselves. The forbearance required to maintain the integrity and effectiveness of market processes is of a not dissimilar nature.

The institutional instability and disorder created by re-purposing markets in the name of 'delivering' specific outcomes from the relevant transactional processes should, therefore, be a major public policy concern, particularly in highly commercial society. It is therefore unfortunate for its public that Britain does not appear to be performing well in this respect, notwithstanding the country's longish history of dealing with the relevant policy issues. Perhaps the outstanding example here is the recent financial crunch. Banking/supervision has a critical role to play in securing the integrity of a monetary system whose collapse would lead to a massive increase in the costs of exchange transactions across the whole economy: these market rules matter a great deal. Yet governments in Britain, the USA and a number of other countries have shown a marked propensity to use the banking rules for other purposes, most notably to subsidise the provision of credit in general and of credit to some sub-sets of the public (e.g. those requiring finance for housing) in particular. In so doing they re-purpose the relevant markets, significantly increase the complexity of the task of developing rule books by asking markets to serve two conflicting objectives (lower transactions costs, cross-subsidisation of channels of credit), and hence increase the risk of banking collapse. In the words of a recent book title, the re-purposing makes the relevant markets *fragile by design.*[22]

Banking supervision experience also indicates that the creation of independent regulatory bodies is not itself sufficient to address potential problems of institutional instability and disorder. The delegation of powers and responsibilities to such bodies helps to some extent in dampening the harmful effects of volatility in political preferences, but the specification of delegated duties/objectives also matters a good deal: conflicting objectives (e.g. lower transactions cost, cross-subsidised credit flows) tend to contribute to instability/fragility as does capricious tinkering with those objectives by politicians.

In conclusion: some implications for the conduct of regulatory policy

A clearer perception of the fundamental purpose/function of markets coupled with a recognition of the persistent tendency to seek to re-purpose markets – i.e. to attempt to use these economic institutions for purposes other than that for which they have developed and adapted – potentially allows us to add greater precision to debates about public regulation. This is an area where there often has been a considerable degree of underlying confusion, not least

[22] C.W.Calomaris and S.H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*, Princeton University Press, 2014. For a much earlier, prescient summary of the problem see S. Peltzman, "The Control and Performance of State-Owned Enterprises: Comment", in P.W. MacAvoy, W.T. Stanbury, G. Yarrow and R.J. Zeckhauser, *Privatization and State-Owned Enterprises*, Rochester Studies in Managerial Economics and Policy, Kluwer Academic Publishers, 1989.

because the same word, regulation, is used to refer to different types of conduct that, in reality, are seeking to achieve rather different purposes.

Markets as defined are inherently regulatory in nature – they regulate or govern commercial behaviour – but they do so in ways that, if effective, expand the opportunities for mutually beneficial interactions between buyers and sellers by reducing the costs of exchange. Those with specific responsibilities for market rules, including changes in market rules, who discharge those responsibilities in accordance with the fundamental purpose/function of a relevant market are themselves market participants and the rule-books can be said to be complementary to (i.e. supportive of) the transactional processes that they govern.

Public regulation is concerned with a particular sub-set of market rules, not the whole set. It is necessarily concerned with governance issues (i.e. with governance of the rule-set that structures exchange transactions), but the task of market governance is not reserved for only one particular economic actor or agent. Market participants themselves necessarily also play roles, particularly in relation to the development of the more informal aspects of the rules.

The establishment and adaptation of market rules (which in turn 'govern' the transactional processes) is therefore best seen as a process of *co*-determination. This co-determination process cannot be comprehensively hierarchical, if only because the informal parts of the rules (the market culture) are largely beyond the control of public regulators, although it is clearly not the case that all parties are equally responsible for all aspects of the system of rules. There is a division of roles and responsibilities, but just as the division of labour does not imply hierarchy in exchange transactions (although it often does so within organisations), so it is with the division of roles and responsibilities for market governance.

This is not how things are usually perceived in the current political climate. More often than not public regulation is thought of as something located somewhere *outside* the market, usually 'above' it in some vaguely conceived hierarchical sense. This is unhelpful: it is conducive to market abuse because it tends to fuel the notion that, in performing market governance functions, a public regulator can use market rules as an 'instrument' to achieve purposes other than reducing costs of exchange without risk of causing significant economic harm.

Similarly unhelpful is the reliance of much contemporary theorising that frames the tasks of regulation in terms of metaphorical principal-agent relationships, an approach that tends to imply a hierarchical structure in which regulators set incentive structures and other market participants react passively and mechanistically. That is not how things are: via their economic interactions all market participants are rule-makers to some degree or other. This is necessary because it is infeasible for an overarching, formal set of rules to provide effective, co-ordinating behavioural guidance across the myriad circumstances in which economic transactions take place.[23]

[23] Current enthusiasts for the use of behavioural economics in public policy risk falling into the same trap if they think that government departments and regulators can proceed on the supposition that, say, consumers are passive slaves of their own heuristics (i.e. their own rules of thumb for processing information and making decisions). Again, the reality is simply that they are not: the behavioural patterns are *endogenous*, not givens,

Given these and earlier points, let me tentatively suggest a two-way categorisation of types of regulation of markets:

- *Congruent or supportive market regulation*, which seeks to serve the same purposes as the institution of the market itself, i.e. reducing the costs of exchange transactions. This type of regulation is concerned in particular with reducing or eliminating barriers to and restrictions of trade, or indeed anything that might stand in the way of potential, mutually beneficial economic interactions between buyers and sellers.[24] It also encompasses rules directed at fraud, deception, bad faith trading and the like *to the extent that such conduct has the effect of raising the costs of transacting in the relevant market*, for example by reducing trust and confidence that transactions can generally be made on the basis of an expectation that they will be mutually beneficial, i.e. in a spirit of reciprocity.

- *Discordant market regulation,* which seeks to determine market rules so as to achieve some other purpose and which most usually takes the form of trying to engineer specific, favoured end outcomes in the transactional processes that are governed by the system of rules. Much current regulation is of this type, for example regulation that is motivated by a desire to 'deliver' specified and specific end-outcomes, as if the social institutions that are markets can be organised in the manner of a pizza delivery service.

Discordant regulation tends to make the governance of transactional processes subservient to the achievement of specified political and/or bureaucratic goals, leading to an organisational/hierarchical approach that is antithetical to an effective market culture designed to support horizontal interactions among buyers and sellers. It is, at bottom, hostile to market society, an institutional structure that has served the public well for many centuries. If this is the 'new politics of markets', it would be best abandoned at the earliest opportunity, but I suspect that its after-effects will linger.

Britain was relatively quick to industrialise and relatively quick to de-industrialise, reflecting perhaps the adaptability of a market society (discussed in the Annex) in adjusting the balance of 'vertical' and 'horizontal' forms of economic co-ordination as circumstances change. Political institutions were also quick to adapt to pressing needs for a shift to vertical forms of co-ordination and for temporary re-purposing of markets when faced with existential threats posed by the two, major wars of the twentieth century. They were, however, much slower to adapt to subsequent, peace-time conditions and a proclivity for discordant regulation seems to have become embedded in public policy, which, if anything, has strengthened rather than weakened over time.

The root causes for this situation are matters for conjecture. One contributory factor may have been relatively weak international, inter-market (jurisdictional) competition in the aftermath of

---

and adapt over time to changing information and changing circumstances, including changes in the behaviour of regulators.

[24] For completeness, it should be added that the judgment that mutually beneficial transactions are a good thing is subject to the classic qualification that the transactions in question do not cause significant, uncompensated harm to others, whether or not those others be market participants themselves.

the wars, which has allowed organisational cultures to become embedded across a wider domain of economic activities. Politicians have, willy nilly, found themselves confronted by two different types of tasks: running public *organisations* such as health, welfare and educational services and state-owned enterprises and participating (via legislation and formal regulation) in the governance of markets. These are different tasks, requiring engagement with different cultures and consequently requiring different skills. In the absence of clear conceptual distinctions, it is perhaps not surprising that muddle and confusion are the order of the day.

Whatever the causes of the current state of affairs, however, the international position has changed: jurisdictional competition has intensified and the economic costs of discordant regulation are tending to grow. Irrespective of where the boundaries between the economic domains of markets and organisations lie at a particular time – which is an issue of great importance in itself – there is, I think, much to be said for a clearer recognition and a clearer separation of the types of policy approaches most likely to be effective within the two spheres.

My focus has been on the domain of markets and on the tendency to see these institutions as instruments for the achievement of specific goals for which they are not well adapted, i.e. to approach them as if they were part of an organisation (exemplified by the UK plc metaphor), which they are not. Changing this mind-set will not be easy, but I hope that seeing markets for what they are – institutions that serve to facilitate economic interactions among individuals and organisations by lowering the costs of exchange transactions – will be at least a small step in the right direction, toward clearer distinctions in policy approaches to the different tasks that confront today's policymakers.

With specific reference to public policy toward markets, the broad, pressing questions at the moment are, I think: whether those with most influence on the formal sub-sets of market rules are capable of developing that *"profound basic trust in the community-building abilities of the market"* that has characterised British thinking of the past (see Principle 3 and the Annex for further explanation); of recognising and taking proper account of the likely adaptive responses of a (non-deferential) market culture in the face of capricious meddling (see Principle 2); and of forbearing to use markets for purposes for which they have not evolved or been developed (see Principle 1). If these things prove feasible, it may even be possible that the public will eventually come to see political contributions to the governance of markets as, on balance, a source of institutional order rather than (as appears to be the case now for many) disorder.

Annex

Learning from experience: some observations on the commercial history of England

The theses of the paper have been put forward in a relatively abstract and general way, but a multitude of case studies could be developed from contemporary regulatory practice around the world to add flesh to the bare skeleton that has been presented. Just about every exercise in policy making with which I have been engaged over a forty year period would illuminate some or other of the points, usually several.

To illustrate at this level of detail, however, risks missing some of the more general lessons that are available from experience about the features of successful public policies towards markets. It is an interesting aspect of these features that, whilst the relevant institutional arrangements and transactional processes of markets are capable of great complexity, the principles of good economic policymaking are relatively simple and straightforward to grasp, have been known reasonably well for some time now, are well explained in the classic works of political economy, and have been abundantly illustrated in the course of economic history. What I think has proved much more difficult is simply to apply what is known when faced with particular and specific policy contexts: the temptations to re-purpose markets appear to have been irresistible in a wide variety of places and time periods. The main indictment is not that we know little about the properties of economic systems, but that we fail to make good use of the little we know.

Given these points, I have therefore chosen to add a little flesh to the bones by means of a *tour d'horizon* of the commercial history of England. This history, I believe, confirms the efficacy of the classic political recipe toward markets: neither *laissez faire* nor central planning nor capricious meddling[25], but rather strong governance based on what I have called a *congruent* approach to regulation/policy that is directed at a relatively limited range of issues and has no ambitions to roam wider. Such a *tour d'horizon* also provides scope for some more speculative comments on the intersections of political economy with other social sciences, and it with these that I will end.

England is perhaps the most studied example of the development of a market society in which the commercial culture is simultaneously both highly individualistic and deeply social, a place where there is a widespread, shared attachment to economic freedom and to individual liberty coupled with a widespread, shared attachment to rule-books, whether they be associated with parliamentary democracy, with the organisation of religious groupings or trade unions (the word 'chapel' features prominently in both), or with the various sports whose rules a boastful

[25] It can be noted in passing that the supportive rhetoric used to justify a meddlesome approach is not infrequently based on the 'Goldilocks Frame' which places the favoured choice somewhere between two, unpalatable alternatives, here *laissez faire* and central planning, insinuating that it is 'not too hot, not too cold, but just right'. Popular though the Goldilocks Frame is – it features in large numbers of regulatory impact assessments – the rhetoric has no generally substantiated rationale. Mixing approaches can lead to muddle and to inferior performance relative to one, and sometimes both, of the alternatives: it all depends on the issues under consideration and the specifics of the relevant economic context.

Mayor of London claimed had been first developed in Britain. The dual attachment reflects the dual characteristics of successful markets: a collectively shared system of rules whose function/purpose is to facilitate individual-to-individual social/economic interactions by reducing the costs of these interactions.

Market culture: the informal rules

The exploration of this history can begin at many starting points. My own favourite entry point is the work of a Cambridge social anthropologist, Alan Macfarlane, particularly his *The Origins of English Individualism*, which itself started from research on witchcraft trials in which it was found that the incidence and characteristics of such trials had been significantly different in England than in some parts of Continental Europe. The question then was *why*? Extensive empirical work on parish records revealed a society that, in the high and late medieval periods, was characterised, relative to the comparators, by higher degrees of geographic[26] and social mobility, later age of marriage, more relaxed attitudes toward sexual relations, a denser network of markets, and so on. That is, documentary evidence indicated what might reasonably be described as significant elements of modernism. To Macfarlane, looking through this evidential lens, the past did not look like a foreign country.

Literary sources also point not only to this dualism, but also to the horizontal interactions characteristic of market exchange. Chaucer's *Canterbury Tales* (late 14th century) may, as might be expected in a context that is one of pilgrimage, be weighted toward stories told by clerics and start (in the hands of the later editors) with the Knight's Tale out of deference to the hierarchy of the prevailing social order. However, the Knight is immediately followed by the Miller, the Reeve and the Cook, and the specific context is an assumed storytelling *contest/competition* in which all are participating on broadly level terms under a shared set of rules that provides for a prize of a free meal, financed by the losers, at Harry Bailly's Inn on return to Southwark. The innkeeper is the inventor of the rules of the competition and it is reasonable to infer that he could expect to be financially rewarded for this innovation via charges for the services that he offers to supply (food and drink) at an associated infrastructure facility (the Tavern). The content of the stories signals a non-deferential, competitive, rambunctious popular culture.

Back in the non-fictional world, inns and taverns played an important role in the early, informal development of English market society, as did churches. They provided places where buyers and sellers could expect to meet each other, in the church case at very specific times linked to services. In the jargon of current economic theorising, taverns and churchyards could be said to have provided the infrastructure of trading platforms that brought together groups of buyers and sellers.

Standardisation of aspects of formal market rules

In the post Conquest period fiscally challenged sovereigns came to view these and other forms of local markets (e.g. larger town and village markets) as a source of revenue and sought to

[26] At least at the sub-regional level.

introduce a system of licences or concessions that encompassed obligations to collect taxes on trading activities (i.e. on exchange transactions) for the Crown. This centralisation of control of the right to operate markets, which was hotly contested at the time, effectively made the Crown a participant in market governance across the country and introduced a greater degree of formality and standardisation into some sub-sets of the market rules.

This development of state interest was inevitably accompanied by forms of monopolisation that had some negative implications for market development, such as:

- Prohibition of non-licensed markets so as to prevent erosion of the tax base, enforced with varying degrees of intensity and with varying degrees of success.

- Development of rule that new, licensed markets could not be established within six and two third miles of a pre-existing market, which afforded market operators a degree of monopoly power that they could exploit to remunerate their own activities.[27]

An illustrative example of the implementation of these policies is a case brought by the burgesses of Newcastle in 1290, presumably seeking to weaken inter-market competition (particularly in the sale of fish), against the Prior of Tynemouth for running an unlicensed Sunday market at a location about 6 miles distant from their own local market.[28] The Prior denied that he was doing anything other than acting according to the customs of villages of the area in allowing people to meet, but given that the King's justices found a tumbrel, the presence of fishermen and brewers, a leased oven and "stalls for the setting out of bread, meat and fish" (i.e. what might be called the physical infrastructure of a market), there is a touch of Monty Python's dead parrot in this denial. The decision of the Justice was that, if the Prior wished to insist that he wasn't operating a market, he should suppress all signs of the existence of a market (i.e. get rid of the physical infrastructure).

In assessing the restrictive effects of these aspects of the market licensing policy of the time, it is relevant to note that any form of activity-based taxation is liable to dampen the activity on which the tax is levied. It is therefore unrealistic to judge the policy against a counterfactual in which the Crown would simply have foregone the revenues by pursuing a policy of *laissez faire*. Moreover, the likely restrictive effects in this early historical period appear more limited than those associated with later mercantile policies under which grants of monopoly rights were much more far reaching in their scope (see, for example, the East India Company). The Crown's major interest was in collecting revenues, not in telling market participants how to conduct their lives or their businesses. Crucially, this interest in securing extra revenues provided incentives for the development of congruent regulation of market activity: other

[27] The distance rule has persisted into the twenty-first century (i.e. for a period of nearly 800 years). The derivation of the distance number seems to lie in a supposition that it was possible to walk about 20 miles in a day and that it was reasonable to allow a marginal (most distant) market participant a third of the associated walking time for time trading, a third of the time for getting to market and a third of the time for getting home again.

[28] See R. Britnell, "Boroughs, markets and trade in northern England, 1000-1216", in R. Britnell and J. Hatcher, *Progress and Problems in Medieval England: Essays in Honour of Edward Miller*, Cambridge University Press, 1996.

things equal, the lower the costs of exchange transactions in markets the higher the expected volume or value of trade (the tax base) and the higher the expected revenue yield.

The licensing arrangements also had the major advantage that they helped to establish a large number of market proprietors who had a very specific commercial interest in promoting market trading to increase their own income. In contrast, on the continent the operation of many markets was *bundled* with other, different, institutional aspects of municipal life, so that their operation and development was influenced by objectives other than expanding the volume and value of exchange transactions. As discussed, the existence of multiple purposes serves to constrain the development of markets in ways that increase the costs of exchange (and hence reduce the volume and value of trade).

Interestingly, this proprietorial income derived not only from fees for stands in the physical marketplace, but also from tolls on those coming into markets and towns to engage in exchange activities, whether inhabitants of the surrounding area or itinerant merchants. Other things equal, tolls could be expected to deter geographic movement, but other things were not equal. The revenues from tolls gave market proprietors incentives to develop both physical facilities and the local system of market rules in ways that would attract increased participation from surrounding areas, which they did in competition for such business with other local market proprietors.[29]

Inter-market competition

As argued, a degree of standardisation in rule-sets facilitates inter-market competition by reducing the market-specific investments required for trading in any one market. Where, for example, the customary practices of different markets are highly differentiated, more substantial market-specific investments in acquiring local knowledge will be required and the costs of multi-market participation (a particular aspect of the costs of exchange transactions) will be higher. Thus, variations in something as basic as the system of weights and measures to be used in transactions can add significantly to costs of exchange transactions.[30]

Among the most important aspects of market rules in this regard is the sub-set of the system of rules concerned with providing security to market participants and means of commercial dispute resolution, which had strong bearing on the costs of market participation (and hence the costs of exchange), particularly for merchants. Again, the Crown's interest in revenues from licensed markets was instrumental in it taking a strong interest in achieving a degree of

[29] Meir Kohn ("*Organised markets in pre-industrial Europe*, Dartmouth College, Department of Economics Working Paper, 2003) provides estimates of sources of revenues from the 1299 St Giles Fair in Winchester as follows: stallage and other rentals > 50%, tolls approximately 20%, service fees approximately 10%. Since itinerant merchants would pay stallage/rental fees and service fees as well as tolls, it can readily be seen why they would be welcome visitors.

[30] That the Crown was active in pursuing a policy of standardising weights and measures over a period of several centuries is indicative that the task was far from straightforward. It was also a policy that pre-dated the Conquest: the laws of King Edgar (*c*.959-957) include the statement "let one measure and one weight pass", although there is little evidence of any serious enforcement effort, perhaps reflecting the weakness of central authority at the time.

standardisation in this area, since undue levels of differentiation in practices could be expected to have the effect of reducing the effective tax base.

Examples at the more formal end of cost-reducing institutional innovations based on standardisation of rules include the specialised staple courts set up in London and fifteen other major port cities (late 12th century) and the much more numerous courts of piepowders, described by Blackstone as "the lowest, and at the same time the most expeditious, court of justice known to the law of England".

The latter indicate that the scope of highly formalised standardisation, exemplified by the staple courts, was relatively limited and this too is explicable in terms of a search for lower costs of exchange transactions, with the desirable side-effect for the Crown of expanding market activity and hence the tax base. In England dispute resolution was facilitated by Common Law and it involved speedy pursuit of claims and settlements outside of more formal, established legal processes. Speed was of the essence because itinerant merchants could not afford to wait around in a particular place for claims and disputes to be settled by more formal processes. Hearings at courts of piepowders were therefore quick, short and informal. In 12th century England and Scotland, a decision had to be made within a day and a half (before the third tide) of the accusation. If the court ruled against a defendant and the defendant could not pay the decided amount, his property could be seized, appraised, and sold to cover the costs.

'Balanced' market policies

Whilst a degree of rule-standardisation is favourable to inter-market competition, which relies on traders being able to participate in more than one market, the limited scope of standardisation meant that market proprietors had considerable discretion to innovate in ways that would attract buyers and sellers to their particular market. For example aspects of formal rules might be standardised, but the detailed enforcement of those rules and hence the trust and confidence that buyers and sellers could have in the enforcement of the rules was, in the conditions of the time, highly dependent on local proprietors. In particular, in addition to having incentives to invest in market infrastructures that would facilitate trade, to make market-days more enjoyable social occasions and, more generally, to promote a vigorous market culture (i.e. promote the informal sub-sets of market rules in ways that would help reduce costs of exchange transactions), proprietors had incentives to mitigate what I have called direct market abuse (i.e. trading practices that are harmful to counter-parties) so as to attract business from other licensed markets, from unlicensed markets (which continued to exist in some abundance) and from off-market trading.[31]

Since direct market abuse exists on account of some or other imbalance of power between buyer and seller that is of sufficient magnitude to lead to material, enduring harm[32] to trading

[31] That is, exchange transactions that do not depend upon a 'prevalent' system of rules, but rather on what a buyer and a seller simply agree between themselves. An example of off-market trading in the medieval period is to be found in the practice of some merchants, acting as agents for large buyers, to visit individual sheep farmers and negotiate directly for purchases of wool.

[32] The qualification here is to exclude harm from losses incurred in voluntary trading that are attributable to individual mistakes. For example, a buyer may 'experiment' by purchasing a product or service with which

parties, a market proprietor whose own revenues depended on factors such as trust and confidence in the relevant transactional process had incentives to maintain some sort of balance of power between buyers and sellers. Adopting an older terminology it might be said that there was a proprietorial interest in preventing the setting of 'unjust' prices in a particular market. Today, we might say that a market proprietor had interests in promoting 'competitive trading' or 'fair trading', where those terms are to be interpreted in terms of a rough balance of power between the two sides of the market, with neither side holding a whip hand.[33]

The effects of early English market policies

From the records historians have identified the existence of a vigorous market society in England back to 'time immemorial' (i.e. pre the Statute of Westminster, 1275). The development of the dualistic culture, concerned simultaneously with individual liberty and 'the rules', no doubt stretches further back and contains large Anglo-Saxon and Nordic contributions. Montesquieu conjectures origins in German forests, but whatever the earlier history by the high middle ages we observe a dense infrastructure of integrated (via the activities of itinerant merchants) regional markets.

With village and town markets numbered in thousands within a relatively small land area, few had to walk very far to engage in market activity. The "extent of the market" was wide enough that few were compelled to rely on subsistence agriculture. There was already scope for division of labour and the wider sociability characteristic of market societies. Culturally, large sections of the population would be familiar with the duality of rule-books and individual freedom or opportunity. As Eisenberg (a German scholar of British history) has put it, in England *"the feudal era ended scarcely after it had begun"*.[34]

It is to be expected that these developments would be conducive to economic growth and so it turned out. A sequence of continental visitors wrote of the high general living standards and the available statistics point to the correctness of their perceptions. For example, *"the productivity of English farming in the mid-nineteenth century, when the other European countries had begun to catch up, was still half again as great as that of France and twice as great as Germany, Sweden and the European part of Russia"* and *"The upswing in coal mining in England had begun some two hundred years earlier than in the rest of Europe, and in the*

---

he/she is previously unfamiliar in order to 'try it out', but then find that he/she does not like it. No enduring harm is done: indeed such experimentation is part of the normal 'discovery' process of transactional activity, not a form of market abuse.

[33] The words 'competitive' and 'fair' have other possible meanings of course, some of which can be distinctly unhelpful and/or misleading when adopted in a policymaking context, and which are almost invariably unhelpful and/or misleading when used in undefined and ambiguous ways. In a much later historical period, the interpretation adopted here is consistent with the relatively sympathetic assessments of labour organisations of a number of the leading, early political economists. Thus collusion among businessmen was generally afforded harsh commentary, whereas collusion among labourers invoked split opinions, reflecting a view that, with the emergence of large employers in the industrial revolution, many local labour markets came to be characterised by a significant power imbalance between buyers and sellers of labour.

[34] Christiane Eisenberg, *The Rise of Market Society in England, 1066-1800*, Berghahn Books, 2013.

early nineteenth century, English coal production was still seven times greater than the combined output of all the Continental European countries." [35]

An 'England problem' or a 'social theorists' problem'?

It can be noted at this point that the historical evidence is not consistent with some of the most influential social theorising about the nature of modern economies. In the terminology of German scholarship the theorising faces an 'England problem'. Marx's theory of the transition from feudalism to capitalism (a word that begins to appear only in the 19th century) immediately looks odd if in England *"the feudal era ended scarcely after it had begun"* and if there was therefore a gap of several centuries between feudalism's demise and what has come to be called the industrial revolution. Similarly, Max Weber's focus on the rationalization of all spheres of economic and social life, which he took to be characteristic of contemporary capitalism, could provide no account of the Common Law and of other peculiarities of the institutional arrangements established in earlier periods that had, at a minimum, maintained a substantial presence in what was regarded, at the time, as the most advanced industrial society.[36]

It is not, however, only continental social theorists who face an 'England problem': so it seems do some of the natives. Consider for example the opening ceremony of the London Olympics, where, for good or ill, the first industrial nation bursts forth upon a bucolic, peasant society, in a quasi-Marxist version of a familiar narrative. This not only mischaracterises what went before, but misses a striking fact: as Eisenberg points out, once industrial capitalism took hold, the pioneer was, relatively quickly, caught up and passed. A market society with an outstanding record of comparative economic performance stretching over centuries appears to have been a less effective performer in developing the 'rationality' required by large-scale industrial and bureaucratic processes.

'Horizontal' versus 'vertical' forms of economic organisation

In all of this 'England' serves simply as a cypher for a more general economic tendency: the underlying issue is a general one and the failure of the social theorists to address it effectively arguably reflects a failure to be interested in and to pay attention to the question raised at the outset of the paper: what is a market? Or, as it was put earlier, in their interpretations of economic history the protagonists simply do not know what they are talking about. Once a market is defined as an institutional form – a system of rules, including habits and conventions, whose function or purpose is to facilitate exchange – many of the puzzles potentially caused

[35] Eisenberg, *op cit.*

[36] A similar problem is to be found in Weber's *The Protestant Ethic and the Spirit of Capitalism.* The proliferation of markets in the high medieval period occurred in a Catholic England, albeit against the background of a not very deferential Catholicism (see Chaucer). Any early linkage between religion and the development of a market society (one in which there is a heavy and ubiquitous reliance on exchange transactions) is perhaps more likely to be associated with the role of 'good faith' norms in lowering the costs of exchange and with the more stringent good faith requirements of Canon Law (compared with, say, Roman Law or formal contract law). Of course capitalism is not necessarily to be equated with a market society notwithstanding the obvious commonality of private property rights – trading of goods and services requires the existence of rights to the things exchanged – but in that case there is a question to what exactly is meant by 'capitalism'. As with public discourse about 'markets', the answers appear to be varied and usually lack precision.

by the factual evidence start to disappear. As Ronald Coase pointed out, markets and organisations (such as a large industrial enterprise or a bureaucracy) are different types of institutional arrangements and there is no obvious and immediate reason why members of a society who perform well in one institutional set up should be expected to perform well in the other.

Indeed, it is arguable that the contrary is more likely to be the case due to the persistence of habits and traditions that are formed via heavy socialisation into one institutional structure, but not the other. Roughly speaking, the two different forms of economic organisation are associated with two different cultures, and switching cultures is not usually a low-cost activity.

Organisations can be said to be characterised by their reliance on 'vertical' social interactions for their co-ordinating effects, based on relationships of authority and the giving of instructions by economic agents at one level of a hierarchy to those at a lower level, whereas markets are 'horizontal' in nature, i.e. there is no necessary hierarchy in the system of rules governing interactions between willing buyers and willing sellers (which, to repeat an earlier point, is not to say that there cannot be power imbalances between the two-sides of the market, as occur when competition is restricted and monopoly emerges).

On this basis, Britain's pioneering position in industrialisation might be explained in terms of two characteristics of its earlier, advanced market society:

- The density of markets in the pre-industrial period facilitated a division of labour that raised productivity and meant in turn that the cost of some of the key inputs required for later, larger-scale industrial processes, most notably coal[37], were already low in comparative terms.

- Market societies tend to encourage inventiveness. The contributions of the division of labour and of competition in the process of buying and selling to the process of *discovering* new and economically valuable information about what to supply and how to produce and distribute it has been heavily emphasised in economics literature, from Smith and J.S. Mill in the classical period to von Hayek and others more recently, but *institutional inventiveness* is also a feature of the dualistic tendencies in a market culture. The latter point is most obvious in the presence of inter-market competition when buyers and sellers have choice over the market in which they are able to transact: it is then just an extension of the standard argument linking specialisation and competition to innovation. However there is also another point: markets are institutions that are dedicated to a rather specific purpose or function, the reduction of costs of exchange, and the extent to which this purpose/function is achieved is open to reasonably precise assessment: there is an obvious metric with

[37] The history of the development of the coal trade in England is a more specific source of illustrations of the general development of commercial society. Thus, at the end of the 13th century we find the Tynemouth Priory drawing income from coal mined on the land of local manors (as well as, by inference, from the North Shields market) and in 1303 the Bishop of Durham granting rights to lesser landowners to mine coal, thereby increasing participation in the market. In this early period, however, there were significant restrictions on development in the form of prohibitions on burning coal in London, for environmental health reasons (perhaps another connection with modernity).

which to measure performance, unlike say in the case of an institution such as monarchy. A focus on reducing costs of exchange, which brings benefits to those engaged in exchange (i.e. to more or less everyone), tends to induce a relatively utilitarian attitude to the institution itself, to the system of rules. If another system of rules can perform the specialised function better, then why object to the change?[38]

A combination of these two factors – inter-market competition and a specific, assessable institutional purpose/function – may provide an explanation of one of the more general cultural themes addressed by Eisenberg, the tension between tradition and modernity. She notes that, in considering the relevant knot of issues, *"The German contributors to the discourse tend to emphasise the profound experiences of loss that go hand in hand with the process of commercialization and predict a longer-term development in the direction of a crisis, since in its triumphant procession, modernity has had a tendency to destroy its own traditional foundations."* In contrast, she points to the tendency of British scholars to emphasise the notion of the 'invention of traditions', exemplified by the development of popular culture in the late 19th and early 20th centuries, of which association football and music hall are illustrations, saying that *"... British scholars express a profound basic trust in the community-building abilities of the market"* (although I think a qualification is in order here in that 'the market' does not itself build anything – it is not an agent – and the point is rather that reliance on and familiarity with markets promote a cultural approach that tends to induce a propensity to be innovative in the way it engages with rule-books (i.e. institutions)).

Whilst the 'invention of traditions' theme in British scholarship has appeared in the context of relatively recent examinations of social and cultural history, an analogous premise is also to be found in the foundations of political economy. Smith's moral and political philosophy, developed before the surge of industrial capitalism but after a centuries-long development of market society, is characterised as follows in the Stanford Encyclopedia of Philosophy: "*A central thread running through his work is an unusually strong commitment to the soundness of the ordinary human being's judgments, and a concern to fend off attempts, by philosophers and policy-makers, to replace those judgments with the supposedly better "systems" invented by intellectuals."*

Implications for current public policy

On this basis, then, the social theorists' 'England problem' may reflect nothing more than the effects of a longer, broader exposure to reliance, in economic matters, on market activity. Smith effectively took the cultural effects of that history as a given in his own day, but it is not necessarily a given in other contexts. Worryingly for current British economic policy, whereas it may still be reasonable to take the cultural inheritance as a given feature of domestic civil society, contemporary politicians arguably exhibit a tendency to ignore the implications of such

[38] This is not to say that institutional adjustments will necessarily occur quickly, only that the pace of change will likely be speeded up to some extent. For example, although technological developments may create scope for reducing costs of exchange transactions and hence for increasing aggregated gains from trade, some market participants may suffer losses by virtue of the reduced value of their 'investments' in the older way of doing things. Those with such 'partial interests' will usually tend to use any influence they have over market rules, whether formal or informal, to hinder institutional adjustment.

a culture, thereby potentially creating a dissonance between formal governance (particularly of markets) and informal governance (market cultures), i.e. a tendency toward what I have called discordant public policies.

As argued in the paper there are good reasons to be concerned about problems of institutional instability, but they are not the reasons to be found in the tradition/modernity debate of social theory. That debate seems to me to be rather remote from the facts on the ground. To give just two examples:

- British society does not exhibit an unusual propensity for sweeping away its old institutions and at least in some areas of social life it arguably shows the opposite tendency, toward institutional conservatism. What I think the facts show is a capacity to examine and to discriminate among alternative systems of rules, developed to serve different purposes and/or to perform different functions, which might be regarded as a qualitatively different form of rationality to the 'organisational/bureaucratic rationality' that Weber took to characterise industrial capitalism. When the rules have a simple, well-defined purpose (as markets rules do), alternative systems of rules can be evaluated against that purpose in a utilitarian manner. Any *profound* sense of loss has less basis in circumstances where a fundamental objective can be better achieved by new arrangements. On the other hand, where institutions serve more diffuse purposes/functions and it is more difficult to assess the consequences of institutional innovation is it not equally rational, given the potential importance of institutional durability and stability for economic/social co-ordination, to tilt toward a conservative approach to matters of the 'if it ain't broke, don't fix it' kind?

- In any event, the historical evidence on the development of commercial society in England indicates that the differentiation between the traditional and the modern is often overdrawn by social and cultural scholars. The culture of the underlings in Chaucer and Shakespeare does not appear to be radically different from that of people enjoying a night on the town on any given Saturday in Newcastle, other than that the latter have much more money to spend and a much wider variety of things to spend it on. That, I think, using a less *ad hoc* set of comparisons, was roughly Macfarlane's conclusion in *The Origins of English Individualism*.

Finally, to return to what I think is the fundamental problem – a policy approach that seeks to re-purpose markets via what I have characterised as capricious meddling – the historical record may help in identifying more precisely the ways in which this approach can serve as a hindrance to economic progress. First, by subjecting established institutions to a relatively arbitrary rule-change process, it degrades their effectiveness. Second, and possibly even more important, by threatening emergent institutional arrangements with the self-same prospect, it discourages institutional experimentation, adaptation and innovation. The underlying mechanism is the same in both cases: an erosion of the contingent predictability that good institutional arrangements establish and that serves as a foundation stone in the co-ordination of economic activity.