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International Interdependence and Regulatory Power

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Introduction¹

This paper revisits a fundamental question of international political economy: When does cross-border economic interdependence become a source of power? The question is as important in the twenty-first century as it was in the twentieth. The renewed attention to security in the post-9/11 era has emerged along side continued rapid integration of national economies. World trade, currency flows, foreign direct investment and other measures of economic globalization continue to rise. And unlike in the second half of the last century when the two superpowers had relatively few economic ties, today's newly emerging great powers – China and India – have deep and complex financial and commercial interconnections with the US and Europe.

The view that economic interdependence is a source of potential power, not just mutual benefits, has a long lineage traceable to political realism, organizational economics and Ricardian trade theory. Power analyses of interdependence typically focus on the researcher's preferred causal variable in isolation. There are two main approaches. In one, scholars use a structural analysis, whereby levels of relative dependencies (i.e. asymmetric interdependence) predict the distribution of potential power. Lopsided exchange, often measured by the relative size of markets, is seen as a source of power for the less dependent authorities and firms. The approach has most often been applied to explain power dynamics in intergovernmental trade negotiations and international regime outcomes. In the other, analysts use the relative mobility among customers, suppliers and regulators to explain firm-regulator power dynamics. They expect regulatory races to the bottom, for instance, when multinational firms gain alternative locations to home jurisdictions for making fixed investments.

Our analysis of power and interdependence builds on these approaches in three ways. First, we add a new explanatory variable. The traditional approaches assume that the boundaries of jurisdictional authority are constants and congruent with national frontiers, a position rooted in an earlier era. The assumption does not make sense in the contemporary European Union, Commonwealth of Independent States and elsewhere, and probably never accurately portrayed the often-changing power balance between center and periphery in a number of federations. Our model demonstrates that in interdependent relationships, changing jurisdictional boundaries affect the potential power of authorities. Second, we reconceptualize the relative mobility variable. We find that supplier or customer mobility is a theoretically limiting way of discussing the relative scope of markets. Market scope refers to the space (not necessarily geographic) within which market participants buy and sell products and, like jurisdictional boundaries, is a determinant of the potential power of firms and political authorities. Finally, we combine all three variables – jurisdictional boundaries, market scope and asymmetric dependence – in a single model to make predictions about power dynamics under static and dynamic conditions. This largely deductive exercise reveals that the relationship between economic interdependence and power is significantly more complex than typically portrayed. Specifically, we find that the effects of asymmetric dependencies on potential power are contingent on the frontiers of markets and jurisdictions. Transnational corporations, through the adjustment of their own behavior and political action in national capitals and international organizations, play a major role in transmitting the effects of an altered power dynamic.

Our re-specification of classic interdependence models helps to advance four core IPE debates concerning power dynamics in regulatory affairs: It suggests conditions under which to expect the California effect as opposed to a regulatory race to the bottom; offers a logic for understanding increased EU bargaining power under conditions of continued market fragmentation; challenges functionalist accounts of regime formation; and builds on recent research concerning the relationship between public authorities and private corporations. While we focus here on power dynamics in economic regulatory affairs among political authorities and between authorities and corporations, our analysis has implications for interdependent relationships in general.

Power and Interdependence – national markets, footloose capital and global consumers

The two leading approaches to power and interdependence stem from different scholarly traditions. The first blends themes from political realism, which expects power relations and concerns about relative gains to underlie state-to-state interactions, and organizational economics, which associates firm size and relative market concentration with the ability of companies to exert market power over prices (Waterson 1984).² Albert Hirschman's realist rebuke of idealist trade theory remains a potent influence on IPE scholarship (Hirschman 1945). A harmony of interests and mutual benefits are only two of several possible consequences of economic interdependence, he reminds his readers. Using economic relations between Nazi Germany and the smaller

¹ The authors thank the George Washington Center for the Study of Globalization (GWCSG) for its generous research support. An earlier version of this paper was presented at the 102nd Annual American Political Science Association Conference, Washington DC, September 1, 2005.

² See for example (Keohane and Nye 1977; Knorr 1977; Baldwin 1978; Mansfield 1992; Simmons 2001).

countries of Central Europe, Hirschman demonstrates that large nations may and have exploited asymmetric interdependence to achieve foreign policy goals. Hirschman's ideas about the "influence effect" of trade are evident in Keohane and Nye's original distinction between levels of sensitivity and vulnerability in interdependent relationships as well as in a range of contemporary work that finds jurisdictions able to exercise influence when their import supply is elastic and the target country's import supply is inelastic. A nation can most effectively make demands when competitors are highly dependent on its exports and the competitors' imports are easily substitutable.³

In borrowing the concept of market power from organizational economics, international relations scholars make an analogy between firms and countries.⁴ Just as firms with monopolies (dominating supply) or monopsonies (dominating demand) influence relative prices and the behavior of other firms, so too nations with major shares of world production or consumption in a given industry shape policies of other nations and the rules governing exchange (Aggarwal 1985). While the analogy has enjoyed widespread usage, scholars have not applied it in a consistent manner. James and Lake (1989) use the actual term 'market power,' by which they mean the ability of a jurisdiction to influence international prices and the terms of competition in the global economy. Here, trade policy decisions made by the dominant power alter relative international prices and, via pressure from their own producers and consumers, prompt foreign governments to adjust trade policies.⁵ Simmons (2001) adopts the same concept, without using the terminology, as one of her four mechanisms by which the US influences foreign financial regulatory choices. Similarly, David Vogel focuses on the role that market power played in extending the reach of government rules in the international economy. His work on environmental regulations in California demonstrate that a jurisdiction may leverage the importance of its market to shift the preferences of producers in foreign jurisdictions (Vogel 1995; Vogel 1997). Not wanting to face the transaction costs of complying with multiple regulatory regimes, business in other countries may actually push for reform domestically in order to create a common set of regulatory standards across jurisdictions.

Other analysts apply the same basic logic – that large markets comprising a dominating share of world trade create market power – to explain other types of outcomes. Long (1996) and Shambough (1996) tie market power to the effectiveness of positive and negative sanctions (Long 1996; Shambough 1996). Aggarwal (1985), Oatley and Nabors (1998) and Richards (1999) make similar arguments to explain regime change. Aggarwal, for example, argues that the international regime governing textiles and apparel changed as the size of US consumer markets (relative to Europe's) diminished. More generally, the regime scholarship demonstrates that nations endowed with market power have the ability to set the terms of international negotiations and thereby affect their outcomes (Oatley and Nabors 1998). In recent work, scholars emphasize how negotiations occur in the shadow of the reversion point, typically viewed as the status quo absent negotiations, when no agreement is reached. Jurisdictions with market power have the ability to shift the reversion point and thereby act as agenda setters altering the preference ordering of the other players and influencing the outcome of negotiations (Richards 1999). Finally, unlike many of these examples that showcase the market power concept in arguments supportive of the hegemonic stability thesis, research on optimal tariff policy – the ability to raise national welfare through protectionism – uses

³ John Conybeare explains the logic of the argument:

...large countries facing small countries are much more likely to improve their income with an optimal trade tax, even if the small country retaliates. The size factor operates in much the same way that it does when there is asymmetry between firms in a market; the larger the firm relative to the rest of the market, the more likely it is to be able to reap monopolistic profits by manipulating the overall market price and quantity supplied.

Large countries should have a relatively higher price elasticity of demand for the products of a small country than the small country has for the products of the large country, due to the former's wider range of substitutes. A small country is likely to be more dependent on a particular import from a large country, and therefore less likely to reduce its demand for that product if the large country imposes a price-raising tax on the good. (Conybeare 1987) p. 25.

⁴ Waltz makes the same move in Chapter 6 of *Theory of International Politics*.

⁵ "In the second face," James and Lake write, "the hegemon uses its international market power, or its ability to influence the price of specific goods, to alter the incentives and political influence of societal actors in foreign countries. These individuals, firms, or regions then exert pressure upon their governments for alternative policies, which (if the hegemon has used its market power correctly) will be more consistent with the interests of the dominant international power. This is a "Trojan horse" strategy in which the hegemon changes the constellation of interests and political power within other countries in ways more favorable to its own interests" (James and Lake 1989, 4).

the concept to arrive at the opposite conclusion. Johnson (1954) and Gowa and Mansfield (2004), for example, argue that, because of its market power, a large economy has incentive to reap the benefits of protectionism.

Thus, over the last half century, the proposition that asymmetrical interdependence, measured in terms of relative market size,⁶ is a source of power has proven extremely resilient and quite critical in research concerned with the role of economic hegemony in constructing international economic stability, the creation and persistence of international regimes, the efficacy of positive and negative sanctions, and the international diffusion and convergence of policies across countries.⁷ Scholars have generally been explicit about the limits of what relative market size purportedly explains and have made generous use of *ceteris paribus* clauses. For Keohane and Nye, market power is a structural variable that is a determinant of potential power in bargaining situations rather than a source of influence over particular outcomes. For Aggarwal, by contrast, oligopoly power shapes outcomes of the particular regime he examines. Mindful of these limits and the benefits of parsimony, we argue that the inclusion of two additional variables greatly improves the approach's explanatory power without diminishing simplicity too drastically.⁸ Our model specifies conditions under which asymmetric interdependence leads to potential power over regulatory outcomes.

The second approach to power and interdependence has several influences including international trade theory, especially the Ricardo-Viner (or specifics factor) model which emphasizes the relative mobility of capital, labor and land,⁹ Hirschman's *Exit, Voice and Loyalty* (1970) and the second-image-reversed literature associated with Gourevitch's classic article with that title.¹⁰ The core proposition is that, within interdependent relationships, relative mobility of actors is a determinant of influence. Those who can credibly threaten to exit are said to wield influence over those who cannot.

With the return of global finance since the breakdown of the Bretton Woods monetary arrangements, most scholarly attention examines the effects of rising levels of capital mobility on domestic battles over institutional arrangements,¹¹ macroeconomic policies¹² and intergovernmental negotiations concerning the global rules of exchange.¹³ National authorities in competition with their foreign counterparts to attract fleet-footed owners of financial assets are expected to adopt capital-friendly policies and institutions and bend to corporate pressure. A major theme of this approach, albeit a highly contested one, is that internationally mobile firms and asset managers will place relentless pressure on national governments for regulatory concessions (Strange 1996; Tonnelson 2000). These race-to-the-bottom arguments stress the constraints on states as they attempt to govern domestically and internationally.

As implied in the above example of Vogel's California effect, the race to the bottom thesis is controversial. For every empirical instance supporting its validity scholars have offered counter examples. By unpacking assumptions behind the concept of mobility, our model is able to contribute to debates about the conditions when a race to the top or bottom is likely. The key conceptual point is to recognize that the mobility of capital owners and other market participants is not just a characteristic of the underlying asset (whether specific or non-specific) but also of rules that determine where these participants can have access to buyers and sellers. The owners of non-specific assets, after all, do not gain influence against their own government unless a foreign authority offers them

⁶ Measures include national income, transaction volume, or market concentration. Typical of the literature, Hirschman argues, "...the large country, having a much smaller stake in this common trade than the small country, is able to bend the latter to its will by subtle or not-so-subtle hints that the benefits of this trade might otherwise be withdrawn" (Hirschman 1978, 47). For additional examples see (Conybeare 1987; Mansfield 1992; Richards 1999). Most of these studies recognize the relative nature of market power that any influence garnered from economic strength is conditioned on the size of the other markets in the power relationship.

⁷ Examples include (Lake 1993; Long 1996; Shambough 1996; Oatley and Nabors 1998; Richards 1999; Simmons 2001). For a more critical interpretation of the importance of market power for political influence see (Wagner 1988).

⁸ Simmons similarly adds complexity to the basic market power hypothesis by elegantly weaving market power, actor preferences and process in a single two-by-two model (Simmons 2001).

⁹ Frieden 1991; Frieden and Rogowski.

¹⁰ See (Gourevitch 1978; Gourevitch 1986).

¹¹ See essays in (Keohane and Milner 1996); also, for a good application, see (Laurence 1999) on London and Tokyo's Financial Reforms.

¹² Webb 1991; Goodman and Pauly 1993.

¹³ Kapstein 1992.

an alternative to domestic customers or suppliers. The relative specificity of an asset is often constant.¹⁴ What empowers a non-specific asset is not its mobility, per se, but permissive rules, such as the liberalization of capital accounts, that allow markets to expand beyond national borders. This is why we use “market scope” rather than mobility levels as a determinant of potential power.

Finally, our analysis of interdependence and power does more than reconceptualize one explanatory variable, mobility, and combine it with another, asymmetrical interdependence. We also add a third: the boundaries of jurisdictional authority. In doing so, we bring out in the open an independent variable introduced by the constructivist turn in international relations,¹⁵ yet absent in most previous political studies of interdependence. The effects of jurisdictional boundaries went largely unnoticed during the last sixty years, as there was a general congruence between national regulatory authority and markets. Yet like consumer and producer markets, the frontiers of authority no longer necessarily align with national borders, as the collapse of the Soviet Union and the intensification of the European integration project exemplify. Such developments raise questions about the impact of denationalization of political authority on power dynamics.

In the following section we reexamine the relationship between power and interdependence in the setting of international economic regulation offering a theory of regulatory power. By synthesizing the scope of markets, jurisdictional boundaries and asymmetrical interdependence, we develop a grounded analytic model of influence in the international economy.

The Sources of Regulatory Power

We are primarily interested in the roots of extra-national influence in economic regulatory affairs. This section identifies some of the key determinants of a jurisdiction’s ability to alter the behavior of foreign firms and authorities, something we term regulatory power. Regulatory power shapes the potential influence of authorities and corporations based in one jurisdiction on the regulatory decisions and arrangements in another. Like other structural variables, the distribution of potential influence does not determine bargaining and other outcomes, which reflect political process and actor preferences as well. Nor is regulatory power the only source of potential influence. Thus, we follow a long tradition of isolating power dynamics and making ample use of the *ceteris paribus* clause.

The fundamental question is what transforms an interdependent economic relationship into regulatory power? Much of the existing literature, as noted above, either implicitly or explicitly relies on the relative size of national consumer markets (i.e. which country’s firms are more dependent on other’s consumers or asymmetric interdependence) as a predictor of regulatory power. Purchasing capacity of consumers or production capacity of suppliers in the domestic markets is said to act as a lever *vis-à-vis* foreign firms, which rely on the profits generated in that market, and their home regulators. Such asymmetries are thus seen as a source of regulatory power.

While market size may sometimes be a determinant of regulatory power, this approach explains only a subset of cases and runs the risk of under- or overdetermining a jurisdiction’s potential influence for at least two reasons suggested in the previous discussion. First, markets are not exclusively national. Since the 1970s, technological and regulatory changes have integrated a number of markets freeing producers and more recently consumers from their national borders, a development that alters the power dynamics of regulatory authority. Second, the boundaries of regulatory jurisdictions vary. While authority over a market has traditionally been exercised by national governments¹⁶, in an increasing number of markets authority has an extra-national flare. Determining regulatory power means identifying the regulatory authorities with which firms must comply. Drawing on recent work concerned with evolving sovereignty norms and globalization, our argument thus turns on the fact that neither markets nor political authority are necessarily circumscribed by national frontiers (Kobrin 1998; Sassen 1999).

In short, we propose de-linking markets and jurisdictional authorities from a particular geographically delimited domain (i.e. states) in an effort to understand the nature of international regulatory influence. We therefore isolate two critical factors – market scope and jurisdictional boundaries. For the purposes of constructing ideal typical power relationships, we conceive of each dimension ranging between national and extra-national. Some markets, such as the market for health care insurance, have a primarily national consumer market while others, such as the international market for currencies has a distinctly extra-national consumer base. Similarly, jurisdictional authority for some markets, including many labor markets is fundamentally national, while others, such as the European market for telecommunications is extra-national overseen by European Union authorities. As

¹⁴ Technological change such as the introduction of new electronic technologies may indeed alter relative asset specificity.

¹⁵ See (Ruggie 1993; Rodrik 2000).

¹⁶ To simplify, we leave the issue of sub-national authorities for the final section of the article.

the two determinants – boundaries of both market size and regulatory jurisdiction – vary, the extent and location of regulatory power change in fairly predictable ways.

In order to isolate these relationships, we limit our analysis to consumer markets and make two simplifying assumptions. First, we presume high levels of interdependence but hold the levels of asymmetric dependencies constant. This means that firms rely heavily on foreign markets, operating in foreign jurisdictions or selling to foreign consumers. The larger the market, the more foreign companies depend on it for revenues, and the degree to which any one country’s firms are dependent on another’s consumers does not change. Second, we assume that regulatory capacity exists and that market participants believe this to be the case. In other words, a regulatory authority has the ability to monitor and enforce a set of market rules in a given jurisdiction. Whether firms operate within the given market or merely sell their goods from afar, the assumption is that the regulatory authority has the resources to implement its regulatory regime and companies know it.

Given these assumptions, our model predicts that regulatory power varies as the frontiers of markets and regulatory jurisdictions shift from national to extra-national, resulting in four ideal typical cases of power dynamics (depicted in figure 1). The remainder of this section discusses each type and offers illustrative cases. In the next section, we examine the effects of shifting from one to another.

Figure 1: Rethinking Regulatory Power¹⁷

| | | | |
|---|----------------|---|---|
| | | Scope of Consumer Market | |
| | | National | Extra-National |
| Boundaries of (Regulatory) Jurisdiction | National | Type I: <i>Sovereign Congruity</i> (NMS determines PRP) | Type II: <i>Sovereign Mismatch</i> (NMS does not determine PRP) |
| | Extra-National | Type III: <i>Transnational Mismatch</i> (SNMS determines PRP) | Type IV: <i>Transnational Congruity</i> (MS = PRP) |

Type I: Sovereign Congruity

Sovereign congruity describes the case most familiar to International Relations scholars. Here, consumer markets and regulatory authority are national. Ceteris paribus, relative market size determines regulatory power because foreign firms must comply with national regulations to sell to national consumers. As the size of the national market grows compared to foreign markets, national authorities wield greater sway over foreign firms. These firms may then press their own regulators to take action in order to ensure access to the large market and reduce regulatory differences that raise compliance and other transaction costs. Companies wanting access to important markets play the crucial role of transmitting foreign influence to home officials.

Under sovereign congruity, differences in market size thus yield lopsided levels of regulatory power. This is Hirschman’s point when he shows that Nazi Germany deliberately fostered asymmetric interdependence in order to gain influence over its Eastern European neighbors and Vogel’s underlying message when he demonstrated California’s regulatory power in shaping environmental rules in other industrialized nations. The sovereign congruity case is also well illustrated in the regulation of financial markets in the 1980s and early 1990s. Most US capital markets dominated their foreign competitors. No foreign alternatives, for example, could supply equivalent amounts of equity financing at the same price. Foreign companies wanting to sell shares to raise capital flocked to New York and complied with US laws, despite significant additional compliance costs.¹⁸

¹⁷ Assume: Extensive economic Interdependence, constant levels of asymmetries and regulatory capacity. MS = Market Size; NMS = National Market Size; PRP = Potential Regulatory Power.

¹⁸ Ball 2004

The transatlantic conflict over accounting standards demonstrates how regulatory power, stemming from the market asymmetries, translated into US intransigence towards EU requests for a mutual recognition regime. In the 1990s, European authorities at the EU and national levels proposed a mutual recognition regime, whereby EU companies with US listings would use national accounting standards and vice versa,¹⁹ but American regulators showed little interest and ignored the demands. The European authorities wanted to reduce the high costs their corporations were paying in producing two sets of financial reports. The SEC, however, expected the rest of the world eventually to adopt US accounting standards.²⁰ US Generally Accepted Accounting Principles (US GAAP) were already accepted by all EU regulators as equivalents in their home markets, and the SEC did not consider European or international accounting standards to be as rigorous. It made no new accommodations, requiring that European companies listed in the US using non-US standards reconcile them with US GAAP.²¹

Type II: Sovereign Mismatch

In the case of sovereign mismatch, markets expand beyond national borders while regulatory authority continues to be contained within them. This is a situation that was first addressed by political scientists in the 1970s in the transnationalism literature and has received renewed attention as communications technologies have facilitated extra-national markets (Cerny 1995). In this scenario, customers – whether asset managers purchasing stocks and bonds or households buying software – become mobile in the sense that they can do their shopping remotely from vendors in whichever jurisdiction they want.

Ceteris paribus, asymmetries in market size have little bearing on relative regulatory power because foreign firms may gain access to national consumers but evade national regulations. The mobility of customers has the potential to create a regulatory race to the bottom. It puts pressure on national officials of high regulation states, who have incentives to convince or coerce their counterparts representing low regulation states to harmonize or otherwise coordinate rules. Additionally, it may raise considerable uncertainty for firms facing multiple regulatory regimes. Companies might therefore support regulatory convergence in order to minimize the transaction costs associated with regulatory conflict. Industry may look to foster hybrid or self-regulatory solutions in an attempt to address the conflicting demands of various jurisdictions. Whether some form of harmonization, mutual recognition, or rival regulatory blocks emerge, it is clear that in instances of sovereign mismatch the likelihood of inter-jurisdictional disputes is high.

The case of on-line content provides a striking example of sovereign mismatch. With the emergence of digital networks, text can be instantaneously transmitted around the world at virtually no cost over the telecommunications infrastructure. While heralded as a great boon to information exchange, the networks also permit the seamless distribution of harmful content challenging traditional notions of sovereignty. The Internet, for example, provides fertile ground to peddlers of hate speech and child pornography, content that is illegal in over 50 countries.²² Conflicts have arisen as national regulatory standards have been applied to the transnational on-line market.²³ The attempted application of French content laws to the Internet service provider Yahoo! proves illustrative. In 2000, A French anti-racism organization took Yahoo! to court in France for making Nazi paraphernalia available on its website. Yahoo! countered that the material was available on the US website and not the French version of the service. The company could not be held responsible or prevent French citizens from visiting the US site. The French court found Yahoo! guilty and demanded that the company create filters to prevent French citizens from accessing the site. The ruling was backed by a fine of 100,000 French Francs (over \$13,000 at the time) per day.²⁴ Yahoo! removed the material, not wanting to damage its reputation, but also began a series of appeals in the US, raising difficult questions of regulatory sovereignty in this new marketplace.²⁵

¹⁹ Commission 1995

²⁰ Simmons 2001; Bach 2004; van Hulle, p. 6. In 1981, the number of foreign companies registered with the SEC was 173. By 2001 it was more than 1,300 (Accountancy Age 2002).

²¹ As discussed below, the SEC stance changed recently as EU regulatory power increased.

²² For an overview of the content debates see (International Chamber of Commerce 2002).

²³ See for example (Harmon 1997).

²⁴ For a summary of the Yahoo! case see (Greenberg 2003).

²⁵ Yahoo! appealed the decision in a Northern California district court. The district court found that free speech protection contained in the First Amendment shielded Yahoo!. But the 9th Circuit court reversed the district court decision, affirming the jurisdiction of the French court. See 169 F. Supp. 2d 1181 (N.D. Cal., 2001) and 379 F. 3d 1120 (9th Cir. 2004). More generally on the question of sovereignty in digital marketplaces see (Kobrin 2001; Mody 2001).

A series of cases involving Internet Service Providers (ISPs) and national content laws have prompted industry to invest in self-policing measures.²⁶ The Internet Watch Foundation (IWF) in the UK, which was founded by a consortium of ISPs, maintains a hotline for citizens to report illegal content. IWF then sends take down notices to firms that violate the law at the same time that they inform law enforcement officials. These national efforts have been accompanied by international private-sector initiatives to address harmful content. The most robust being the International Body of Internet Hotline Providers (INHOPE), which has received considerable support from the European Union.²⁷

While such hotlines help demonstrate the good faith effort of industry to comply with national regulations, they have not ended the content debate. Numerous websites that distribute harmful content have relocated outside of Europe to data havens that maintain limited regulations of online markets. At the same time governments have committed to cracking down on such behavior.²⁸ Those companies that lack a physical presence in Europe, however, face limited extraterritorial exposure to government pressures. For even in the case of Yahoo!, French threats only proved persuasive because the company held assets in Europe.

Type III: Transnational Mismatch

The third type, transnational mismatch, describes cases where markets remain national but regulatory jurisdiction becomes extra-national. This is most common in Europe where the EU harmonizes national regulations but markets remain largely national because of legal, cultural or fiscal barriers. *Ceteris paribus*, the sum of the size of individual national markets under a common regulatory authority determines relative regulatory power despite consumer market fragmentation. This is true because foreign firms must comply with extra-national regulations to sell to consumers in every one of the individual national markets. As in the case of sovereign congruity, the size of the consumer market (this time, the aggregate size of segmented national markets) determines regulatory power. Yet, interestingly, regulatory power is not dependent on market integration, as many in Europe and elsewhere contend. Enhanced regulatory power may occur even in the absence of a truly single market.

Financial services regulation in the last five years provides an excellent illustration. In March 2000, EU leaders began a renewed effort to harmonize regulatory rules and shift to the supranational level the official procedures for producing, implementing and enforcing them. The Financial Services Action Plan (FSAP), proposed by the European Commission in May 1999 and endorsed by the European Council in March 2000, lists Europe-wide legislation deemed necessary to integrate national financial services industries and lays out an ambitious timetable for achieving them. EU policymakers have almost completed the original forty-two measures, which includes passing laws covering money laundering, UCITS (mutual funds), accounting standards, market abuse, occupational pensions, prospectuses and the regulation of conglomerates, and have added new ones.

In February 2002, EU policymakers adopted the Lamfalussy Process, new formal and quintessentially supranational decision-making procedures for expediting the production of EC legislation for insurance, banking and investment services and coordinating, transposition, implementation and enforcement.²⁹ The process has quickened the production, improved the quality and evened the application of new financial legislation.³⁰ The new procedures distinguish between framework laws, which still require passage through the old system, and detailed regulation, similar to US administrative rules, produced by an elaborate network of expert and regulatory committees. It also brings together national regulators in new organizations like the Paris-based Committee of European Securities Regulators (CESR, pronounced "Caeser") and adopts American-style public hearings.

Until the introduction of the FSAP and Lamfalussy Process, US financial authorities jealously guarded their regulatory sovereignty in handling a growing number of transatlantic disputes, ranging from the governing cross-border competition for stock exchanges to the merits of a mutual recognition of accounting standards, as discussed above. Typically, US officials exported American solutions by pressuring, persuading or outmaneuvering their European counterparts and resisted making accommodations to European demands and proposals. If adjustments were going to occur, European national regulators tended to make them.

Since 2001, by contrast, US authorities have made significant concessions in several high-profile transatlantic conflicts, and there are strong indications this behavior will continue. The cooperation in financial services has been institutionalized in new forums such as the "EU-US Financial Markets Regulatory Dialogue" and

²⁶ For a review of European efforts to prosecute harmful content see (Blarcum 2005).

²⁷ "More EU funding for Project to make Internet Safer for children," *Irish Times*, June 11, 2004, 3.

²⁸ See (New York Times 2000; Diebert 2002).

²⁹ Originally, the Lamfalussy Process only applied to investment services. In December 2002 it was extended to the entire financial services industry, including banking and insurance.

³⁰ Lamfalussy 2005.

the Norwalk Agreement of September 2002 and has led to new policies, such as the SEC's new commitment to a mutual recognition regime in accounting standards.³¹ US markets remain by far the largest and deepest for almost every financial asset. As recent studies attest, a single European financial market as a whole still remains a goal, although there have been impressive strides made in particular markets.³² Transferring regulatory authority from the national to the European level has led to a more accommodative US stance because American financial services companies that operate in Europe and earn approximately 20% of their revenues there have much at stake in the shape of the embryonic EU financial system.

Under pressure from US companies to protect their interests and from EU regulators pressing their own and their constituents' agendas, American officials have had to come to terms with newly empowered counterparts. EU officials now have the potential to affect US firms in ways similar to American authorities' influence over European corporations with US businesses. While European choices may benefit US firms by promoting transatlantic regulatory harmonization, they may just as readily harm them through retaliatory responses. Thus, the construction of a European-level regulatory regime triggered new private sector political behavior and US regulatory positions and altered transatlantic and multilateral relations in financial services.

Type IV: Transnational Congruity

The fourth, and final, category is transnational congruity. In these cases markets and authority are extra-national and share the same frontiers. Goods and services cross borders and are overseen by an extra-national jurisdiction. Extensively integrated EU markets best exemplify this type. *Ceteris paribus*, market size (covered by an extra-national jurisdiction) determines relative regulatory power because firms from outside the jurisdiction must comply with the extra-national regulation to sell to extra-national consumers. The extra-national regulator enjoys the aggregated market power of the integrated market. The transnational congruity logic therefore mirrors that of sovereign congruity.

The regional integration effort in the European aviation market offers a useful example of the case of transnational congruity. For much of the post-war period, commercial passenger transportation was fragmented in small local markets, dominated by national carriers and national regulation protecting the domestic market from competition. International flights were regulated through a complex system of bilateral deals between national governments. Each European country, well into the 1990s, had individual agreements with the US on the number of transatlantic flights into and out of their respective countries (Richards 1999).

Through a set of reforms and liberalization efforts, the European Union has constructed an internal market for aviation within Europe. Critical in this effort, national rules on ownership, control, and competition were replaced with community rules on ownership, control, and competition, transforming national carriers into "community carriers". Shifting investment and market access rules to the Community level were bolstered by new European standards regulations: the most visible being the creation of the European Aviation Safety Agency. This internal transformation has spurred fierce price competition within the European aviation market as a host of new low cost carriers go head to head with traditional airlines.

While these internal market reforms went a long way in creating transnational congruity, competence for external relations in the sector was still disputed. Member states continued to negotiate bilateral deals concerning landing rights and gate access with other countries for international flights. In a suit brought before the European Court of Justice (ECJ) by the Commission against the member states, the Court ruled in 2002 that the Commission should be responsible for negotiating agreements with foreign governments seeking access to the single European aviation market. As a result, jurisdictional authority for external affairs has been elevated to the European level.³³

The Commission is now in a position to leverage the collective power of the European market in negotiations with other jurisdictions. And the Commission has wasted little time in developing a robust agenda to push internationally. During negotiations with the United States in 2004, the Commission made several radical demands including a proposal to open domestic market access in the US and Europe to each others' carriers and the 100% elimination of foreign investment requirements. If Europe succeeds, struggling domestic carriers in the US would face tough competition and potentially acquisition from financially healthy European carriers (Calleja 2004). Similarly, the Commission has entered into negotiations with both Russia and China to increase European market

³¹ Put in recent news articles on the subject.

³² Commission 2004a; b.

³³ See (Meller 2003).

access to the two growing aviation markets.³⁴ These demands are backed by a 400-million person market that just expanded by some 76 million passengers with the EU enlargement in 2004.³⁵

Exogenous Changes in Markets and Jurisdictions: Three Propositions

Thus far, we have examined the effects on regulatory power of jurisdictional boundaries and market scope, under static conditions. Our conclusion runs counter to a long tradition in international political economy. Scholars have assumed that the association between power and asymmetries of market dependencies is universal. Our deductive exercise suggests it is instead contingent on the parameters of market and jurisdictional authority. When markets exceed national borders but regulatory authority is exercised within them, what we labeled sovereign mismatch, relative consumer market size is not expected to determine regulatory power.

Having shown, then, that the geographies of markets and jurisdictions are important determinants of regulatory power, we now turn to developing propositions under dynamic conditions. We use our model to derive three propositions about the effects on regulatory power of expanding markets and jurisdictions. The first and second reveal both the limitations of analysis based on a single variable, asymmetrical growth in markets, and the counterintuitive conclusions derived from including market and jurisdictional boundaries. The third specifies conditions when exogenous expansion in the scope of consumer markets leads to the outcomes expected in the power and interdependence literature.

Proposition 1: Changes in relative market size do not necessarily lead to changes in regulatory power. Take the example of an exogenous expansion of markets under an existing extra-national jurisdiction. This is a shift from transnational mismatch (Type III) to transnational congruity (Type IV). Even though small and fragmented consumer markets become integrated at the extra-national level, we predict that regulatory power will stay constant. Once a common regulatory jurisdiction exists, there is minimal “value added” by fully integrating consumer markets. We would not expect the EU’s influence in financial services, for example, to expand as market integration proceeds. The logic is counterintuitive. Since the late 1990s, the integration of regulatory regimes has outpaced the actual integration of financial services and capital markets. Most observers have been surprised by the EU’s regulatory power in bilateral negotiations, as discussed above. They did not expect an increase in European regulatory power until the distant future when markets caught up with regulators.

Proposition 2: Regulatory power may increase, even though market size remains constant. Consider the effects on regulatory power of an exogenous shift in jurisdictional authority from national to extra-national frontiers, a move from Sovereign Congruity (Type I) to Transnational Mismatch (Type III) – with no change in the size or composition of markets. Regulatory power would expand dramatically merely from the change in jurisdictional authority. This is what happened in the area of data privacy regulations as the EU entered the policy domain. Since the early 1980s, European governments including the largest economies of France, Germany, and the United Kingdom adopted comprehensive rules concerning the collection and processing of personal information in the public and private sectors. But by 1990, Israel was the only non-western European country to emulate these regulations. In 1995, the European Union passed a privacy directive that centralized external control over regulation at the regional level. Article 25 of the directive prevents the transfer of personal information to countries that do not maintain “adequate” privacy regulations. The Commission, advised by a network of European privacy regulators, has the authority to determine whether other countries meet the “adequacy” standard. While jurisdiction has been elevated to the extra-national level, markets for personal information concentrated in the banking, marketing, and insurance sectors remain largely national. Since the adoption of the directive over 30 countries ranging from Albania to Argentina to Australia have emulated the European regulatory model. Even the U.S. has been pressured to sign an international agreement, which requires U.S. firms active in the European market to comply with European rules. The shift towards the European model was not predicated on a huge expansion in any one national market or even in the size of national markets within Europe that maintained comprehensive privacy protections. Rather the directive created an extra-national jurisdiction which was empowered to set rules of entry and access. This extra-national jurisdiction, in turn, aggregated the economic strength of the individual member state markets.

Proposition 3: An expansion in the scope of consumer markets without a corresponding expansion in regulatory boundaries creates new conflicts among regulatory authorities. An exogenous extension of markets beyond national

³⁴ See (Borak 2005).

³⁵ For the importance of enlargement to the EU bargaining position see statements made by the Commissioner for Transportation (de Palacio 2003).

borders, a move from Sovereign Congruity (Type I) to Sovereign Mismatch (Type II), is a classic phenomena addressed in the international regimes literature.³⁶ Such a change gives consumers new choices about the jurisdiction under which they will purchase products. Any observed enhancement or diminishment of regulatory power does not derive from an increase or decrease in relative market size, per se. Rather, it stems from choices made by consumers. The potential for fiscal and regulatory arbitrage (i.e. a race to the bottom) pits officials from high tax and rigorous regulation jurisdictions against low tax and lax ones.

Implications and Conclusion

The above synthetic approach to the relationship between power and interdependence helps to advance research in several debates. We conclude by highlighting its potential contribution to four of them. First, researchers tend to emphasize either regulatory competition (a race to the bottom referred to as the Delaware effect) or the adoption of rigorous regulations (a race to the top referred to as the California effect). Our model generates expectations concerning the likelihood of each. Expansion of markets beyond existing borders (Proposition 3 above) creates problems for regulators with high, relatively demanding regulations and tax regimes and pressures them to make adjustments in the direction of low, relatively lax regulatory jurisdictions. By contrast, an expansion in the boundaries of a high regulatory regime (or growth in asymmetric interdependence through the relaxation of our assumption of constant market size in Types I and IV) creates problems for foreign regulators. Foreign firms come under pressure as they face potential market exclusion and the potential of having to comply with multiple regulatory standards across jurisdictions. These costs may prompt foreign firms to support the emulation of relatively powerful authorities' policies, even if these regulations are more demanding. The model makes predictions about potential bargaining power, not outcomes in any particular issue area. In this sense, our expectations are not inconsistent with Scharpf (1999)'s skepticism concerning general propositions for predicting regulatory patterns in the context of economic interdependence.³⁷ At the same time, our model does provide useful expectations about the pressures regulators face in the international economy. These expectations incorporate dynamic as well as static processes into the relationship between economic interdependence and harmonization and thereby can account for variation in regulatory outcomes.

Second, our model helps explain the mysterious growth of EU international influence despite persistent internal market fragmentation. With the announcement of the Single European Act in the mid-1980s, US commentators initially feared that Europe would leverage its new internal market to bully those outside of "Fortress Europe".³⁸ But as it became clear that mutual recognition, not harmonization, would become Europe's integration tool of choice fears dwindled. Similar concerns arose with the creation of the single currency only to dissipate as financial markets retained much of their national characteristics.

Despite continued market fragmentation, Europe has successfully asserted itself internationally in a range of sectors.³⁹ Our understanding of regulatory power explains this surprising result. The creation of extra-national jurisdiction proves sufficient to obtain regulatory power. Extra-national authority, presenting a coherent regulatory framework to foreign firms, shapes firm behavior. Regardless of which national European market firms wish to enter, they have to comply with pan-European rules.

It should be possible to extend this logic to the sub-national level as well. One can imagine, especially among federal polities, that market and jurisdictional scope affect power dynamics at the sub-national level. As the two by two expands to a three by three, interesting implications emerge for regulatory power. Take the case where jurisdiction is sub-national and markets are national. We would anticipate that sub-national public authorities would encounter fierce challenges to their authority from internationally active firms. With multiple exit threats, sub-national authorities face extensive arbitrage pressure. This might shed light, for example, on the disparity between the SEC's international influence in the 1980s and the inability of US state public insurance authorities to shape the international regulatory agenda in the same period.

Third, our model highlights the limits of functionalist explanations employed in current International Relations research. Borrowing from institutional economics, IPE researchers in the functionalist tradition argue that the inherent nature of assets and policy areas largely determine international regime outcomes, political processes and power dynamics.⁴⁰ The underlying logic of these arguments is that the regulation of specific policy domains

³⁶See (Cerny 1995).

³⁷ Scharpf 1999, Chapter 3.

³⁸ For a discussion see (Hanson 1998).

³⁹ The European Union has increasingly asserted itself in a range of sectors including food safety, telecommunications, financial services, and consumer protection. See (Mitchener 2002).

⁴⁰ Put in Keohane on functionalist regime theory (after hegemony), Frieden, Rogowski.

emits inherent constellations of actor incentives and preferences. While taxation yields one type of international bargaining game, social and environmental regulations are said to produce others. As the more sophisticated applications of this reasoning demonstrate, policy type is only one of several variables that shape international regulatory processes and outcomes.⁴¹ Our analysis goes a step further. Instead of focusing on the continuities within issue areas and over time, the model anticipates the dynamic nature of power relations. As market and jurisdictional boundaries change and asymmetries shift, the underlying character of both the “problem” and the “solution” within a regulatory domain evolve. Outcomes, then, are not merely efficiency responses to particular issue challenges. Rather, political transformations in markets and jurisdictional authority alter the balance of power of those competing to provide governance solutions. The politics of transatlantic accounting standards proves illustrative. During the late 1980s, the US dominated the regulatory debate. More recently, however, the EU has become an equal partner in adopting international accounting standards. The nature of accounting standards, presumably a constant, cannot explain this pattern of change. Rather, shifts in jurisdictional authority have recalibrated the power relationships between the two economic great powers.

Finally, our model of regulatory power adds to a burgeoning debate on the role of private actors in the international political economy (Pauly 1997; Cutler, Haufler et al. 1999; Haufler 2001; Sell 2003). While this literature has convincingly demonstrated that private actors are important players in international governance, the evidence is mixed as to whether private actors undermine or enhance public authority. We join a relatively recent research strain that attempts to parse out the relationship between public authority and private actors (Farrell 2003; Mattli and Buethe 2003; Newman and Bach 2004; Posner 2004). Contrary to pluralist analyses, our model addresses the Janus-faced relationship between the two, anticipating when public authority should be able to influence private sector preference and when private actors should be able to pressure for regulatory change. The scope of markets and jurisdictions set the stage, benefiting private actors when markets are extra-national and jurisdiction remains national. Firms are best positioned to exert their preferences when exit remains an option. Public authority, by contrast, benefits under favorable market asymmetries or when jurisdiction is extra-national. Here jurisdictions may leverage their rule-making authority to define the terms of market entry and access, forcing firms to confront the potential loss of vital markets. Private actors may then be both the active force behind regulatory change and the reluctant recipient of public authority demands. The dynamics of regulatory power help to specify the terms of the relationship.

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⁴¹ Simmons 2001.

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