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Is Regulation Beneficial?

When do regulatory subsidies become regulatory burdens? That question is central to the debate over financial regulatory reform in the US. The prevailing wisdom among advocates of deregulation is that US financial regulation, although in many cases originating as subsidy, now imposes significant burdens on US financial institutions that have disadvantaged them when competing in global markets. For example, US regulation has kept financial firms small and specialized in a world in which diversified universal banks dominate; as a result, many US financial institutions may lack the size necessary to compete in global markets. US financial firms have proved skillful at using innovative legal structures to evade regulatory restrictions, but the high transactions costs associated with this strategy eventually may take their toll on the US financial industry, injuring its competitive position.

The logic of this argument appears to offer an irrefutable case for radical financial deregulation. Nevertheless, one of the defining characteristics of late twentieth century US financial markets was the frustratingly slow pace of regulatory reform, especially at the national congressional level. Although financial markets were experiencing rapid and profound transformation, fueled by the economic dislocation of the 1970s, the restructuring movement of the 1980s and the industry consolidation of the 1990s, regulatory transformation lagged behind, fueled more often by agency reinterpretation of old statutes than by bold new legislative initiatives. Even Glass-Steagall, although thoroughly discredited, continued to maintain legal barriers between banking and securities markets during much of the 1990s. And other traditional elements of the US financial regulatory scheme, such as the virtually total separation of banking and commerce, remained intact.
Yet another defining characteristic of late twentieth century US financial markets was the vitality of the US financial industry. Despite their regulatory burden, US financial firms prospered. In fact, US financial institutions were widely viewed as better positioned to succeed in global financial competition than their less regulated rivals. This was not just the opinion of the US financial press, which might be expected to favor the prospects of domestic firms. Non-US observers apparently agreed: a 1993 survey of global capital market users ranked US firms at the top of global investment banks in trading, underwriting and advisory services.

Given the success of US financial firms, competitors may have wondered whether US financial markets were in urgent need of deregulation after all. This raises an important but often overlooked question about the nature of regulatory burden and subsidy: was there a link between the slow pace of financial regulatory reform in the US and the relative strength of US financial firms in global markets? If there was a connection, then the conventional wisdom in the US that regulatory subsidies have become regulatory burdens may not be entirely correct, a possibility that may explain why US financial institutions did not try harder and earlier to achieve the repeal of supposedly burdensome regulatory statutes such as Glass-Steagall.

**Regulation and the theory of equal starts**

As was suggested in Chapter 1, the legitimacy of US financial regulation may be measured by its contribution to promoting fair play on a level playing field. As recent scholarly critiques of regulation make clear, the philosophical preference of US market participants is for open and competitive markets subject to as little government interference as possible. Yet the practice in US financial markets has been for participants to accept significant regulatory burdens and subsidies that affect the starting positions of financial competitors. What explains this contradiction? The answer may be found in the peculiar American conception of competitive fairness. On a level playing field, fairness requires that all competitors enjoy an equal start. Regulatory intervention, in the form of burden and subsidy, is tolerated insofar as it guarantees this equal starting position to all players.

Why is equality of starting position so important to US markets? Equal starts provide competitive markets with their legitimacy, thereby eliminating the need, and public demand, for government regulation of the competitive process itself. So long as every player has