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The European regulatory state and global public policy: micro-institutions, macro-influence

David Bach and Abraham L. Newman

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ABSTRACT Across a broad range of sectors, Europe is increasingly shaping global public policy. Existing research stressing the importance of market size for international regulatory influence cannot satisfactorily account for this. We contend that the rise of the regulatory state within Europe has significant international implications, augmenting Europe's ability to shape global market rules. The article develops an institutional explanation of regulatory influence stressing domestic regulatory capacity. An analysis of two hotly contested transatlantic policy fields – data privacy and financial market regulation – provides a first test of the argument.

KEY WORDS Data privacy; EU external affairs; market regulation; regulatory state; securities.

INTRODUCTION

Owing to globalization and international market integration, debates over public policy and market regulation increasingly transcend borders. While regulatory interdependence in many areas puts a premium on harmonized rules, the distributive effects of public policy pit different camps against one another (Krasner 1991). Who gets to shape global market rules and why is therefore a critical question. Existing research focuses on the role of domestic market size. In a recent contribution, Drezner (2005: 843) sums up the prevailing view that '[s]tates are differentiated by their relative power' and '[p]ower is defined as the relative size and diversity of an actor's internal market.' This article analyses the recent rise of European regulatory influence in global markets to examine whether market size alone accounts for observable patterns. We think that it does not, and hypothesize that a sizeable internal market must be coupled with potent regulatory institutions to yield power over global governance.

Across a range of sectors – financial services, food, chemicals, and telecommunications – Europe has shaped decisively the character of global

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market regulation (Mitchener 2002). This has occurred despite opposition from the US, long thought of as the global regulatory hegemon, and despite the absence of a single European super-state. Our central argument is that the roots of Europe's new-found influence lie in institutional reforms on the member state level and complementary developments in Brussels. These reforms, which focused initially on market liberalization, heralded the emergence of the 'regulatory state' – a shift by governments away from command and control regulation to a reliance on new institutions that set and enforce market rules at arm's length (Majone 1994, 1997). The regulatory state, whose instruments were designed with an eye toward strengthening domestic market competition, increasingly – and to some extent unintentionally – provide European policy-makers with tools to set market rules internationally as well.

The rise of the regulatory state in Europe is closely interwoven with European integration and the construction of the Single Market (Majone 1996). National governments have liberalized a range of sectors and have created new political institutions – regulatory agencies, administrative courts, and ombudsmen – to oversee market competition (Thatcher and Stone Sweet 2002). Concurrent with domestic reforms, policy-makers have crafted mechanisms on the European Union (EU) level to co-ordinate institutions across member states. Europe now has in many sectors the institutional resources to define and monitor coherent regulatory policies and has established the political authority to control access to the Single Market.

We begin by showing that Europe's influence over international market rules has grown markedly in recent years, something acknowledged by both scholars and practitioners. Pervasive explanations for Europe's clout invoke the formidable size of the Single Market. While much theoretical work on patterns of international influence similarly focuses on market size, we argue that such explanations fail to account for intriguing variation over time and across sectors. In the following section, we develop an institutional argument that shows how regulatory state institutions translate latent power vested in the internal market into concrete international influence. The remainder of the article consists of two case studies – on personal data privacy and securities regulation – in which we illustrate and assess the institutional argument. The two cases provide considerable variation in Europe's international influence and internal regulatory capacity across time, offering an ideal setting to scrutinize the variables and causal mechanisms at work. We find that market size is necessary, though not sufficient for global influence, and conclude that the international implications of the regulatory state drive Europe's recent ascendance. The article contributes to a growing literature on the EU's external relations, which highlights the important role of national and supranational institutions for shaping European foreign policy (Ginsberg 1999; McNamara and Meunier 2002; Smith 2004; Meunier 2005). More generally, the study adds to research focused on the important nexus between comparative and international political economy.

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EUROPE'S GROWING REGULATORY INFLUENCE AND THE SINGLE MARKET

Europe's international regulatory influence is on the rise and the US in particular is taking notice. In an article about US lobbyists in Brussels, the *Financial Times* notes that 'there is now a growing realization in many quarters that Brussels, not Washington, is shaping the global regulatory standards companies will have to abide by' (Kirchgaessner and Buck 2005). This sentiment is echoed in the American press. Analysing the effect of Europe's new industrial chemicals directive, *The Philadelphia Inquirer* argues that

> [t]he new chemical rules are the latest example of how the European Union ... has become an economic and political superpower to rival the United States. In the last five years, EU regulators have killed a merger sought by one of America's marquee corporations, General Electric; imposed stiff anti-trust penalties on another, Microsoft; and required Coca-Cola to share space in its refrigerators with Pepsi.
>
> (Dilanian 2005)

Leading scholars join this assessment. Moravcsik (2002) explains, 'In antitrust policy, Brussels applies its law extraterritorially, recently derailing General Electric's planned $42 billion acquisition of Honeywell International – a merger between two US companies. Europe enjoys an equally dominant position in banking regulation, industrial standardization, environmental policy, telecommunications and many other economic matters.' Research supports this claim for areas as diverse as food safety (Young 2003), wireless communications (Glimstedt 2001), and the environment (Bretherton and Vogler 1999). With a recent title, the *Wall Street Journal* captures the views of many: 'Increasingly, Rules of Global Economy are set in Brussels' (Mitchener 2002).

The reason for Europe's growing regulatory influence put forth by diverse observers is the sheer size of Europe's integrating market. Commentators note that Europe's economy has reached rough parity with America's (Reid 2004). For the US Ambassador to the EU, Rockwell Schnabel, the EU's growing regulatory clout boils down to a simple formula: 'Let's face it – you have to deal with them. They have the power of that market' (Fuller 2002).

Academic research supports the notion that a large market yields market power that is tantamount to influence over global public policy. Some studies attribute regulatory influence to overall economic size. James and Lake (1989) call market power 'the second face of hegemony' and argue that hegemons rely on large domestic markets to shape world market prices. Drezner (2005; 2007) develops this argument for international market regulation and contends that only great powers – defined as 'governments that possess large internal markets' – exert meaningful influence. Large markets, he posits, 'have a gravitational effect on producers – the larger the economy, the stronger the pull for producers to secure and exploit market access' (p. 843). A second

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version of the market-size-equals-market-power argument operates at the industry level. Oatley and Nabors (1998) argue that US banking regulators imposed their preferred standards on other advanced economies in the 1980s because the US enjoyed 'financial market power' owing to its dominance in finance. Similarly, Richards (1999) sees patterns of regulatory influence in post-war international aviation as determined by relative market size in that sector.

It would be foolish to dismiss market size as a determinant of international regulatory influence. Yet a focus on market size alone provides an incomplete explanation of Europe's growing might. Europe's assertion of regulatory authority predates the inclusion of 12 new EU member states and exists even though considerable internal market fragmentation persists in many sectors. There is also important variation across industries and policy areas that cannot satisfactorily be accounted for by considerations of market size. While sizeable markets confer power, much work remains vague about how exactly market power shapes international market regulation. What is missing, then, is an understanding of how latent power vested in sizeable markets is translated into actual influence over global public policy.

We suggest that Europe's growing regulatory influence is the by-product of domestic institutional reforms and co-ordination on the EU level that have augmented Europe's 'regulatory capacity' in several industries. By focusing analytic attention on the institutional resources available to policy-makers in a given setting, we can account for variations in influence across sectors and time.

INTERNATIONAL IMPLICATIONS OF THE REGULATORY STATE

With the push towards market liberalization and integration, Europe has undergone an institutional transformation. The rise of the regulatory state signals the move away from government intervention in the economy through nationalization and macro-economic planning toward more arm's-length control to stimulate competition and ensure the provision of social goods (Majone 1997; Moran 2002). This development has transpired at both national and EU levels as individual government efforts dovetail with the Single Market programme (Majone 1996). European governments have withdrawn from directly providing services in fields such as transportation, telecommunications, and utilities through state-owned enterprises at the same time that EU initiatives have attempted to build pan-European markets (Héritier *et al.* 2002). Institutionally, the regulatory state is characterized by a set of agencies, commissions, and special courts that governments have created to define, monitor, and enforce market rules (Thatcher 2002).

The rise of the regulatory state in Europe has important implications for global public policy. For one, the transformation of governance and market competition within European industries has provided the impetus for subsequent debates about global market rules. The regulatory state itself thus contributes to the globalization of public policy. The regulatory

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institutions constructed to oversee liberalizing industries in an integrating market also provide Europe with the necessary institutional capacity to translate market size into international regulatory influence. The intuition behind the argument rests on the micro-institutional revolution that has swept political economy over the last two decades. Following the 'rediscovery' of the state in comparative politics, the idea that *state capacity* structures the realm of possible policy outcomes has become a staple of comparative analysis (Steinmo *et al.* 1992; Thelen 1999). As Evans *et al.* (1985: 351) explain, studies of state capacity focus on 'specific organizational structures the presence (or absence) of which seems critical to the ability of the state authorities to undertake given tasks. In turn, the presence or absence of organizational structures is connected to past state policies, thus underlining the need for historical as well as structural analysis if specific state capacities and incapacities are to be understood.'

Given that state capacity structures the ability of policy-makers to formulate and adopt specific policies in the domestic arena, we anticipate that they also play a critical role when it comes to projecting rules internationally. We introduce the notion of *regulatory capacity* to focus analytic attention on the institutional tools and capacities most relevant for market regulation. We define regulatory capacity in the context of international economic governance as a jurisdiction's ability to formulate, monitor, and enforce a set of market rules. Because the construction of the regulatory state has augmented Europe's regulatory capacity, the EU has increasingly shaped international market rules according to its preferences.

Regulatory capacity is a multidimensional phenomenon. At a minimum, regulatory capacity consists of regulatory expertise, coherence, and the extent of statutory sanctioning authority. These three factors contribute collectively to a jurisdiction's regulatory capacity – high levels of all three are preferable and a complete absence of any renders a jurisdiction impotent. Isolating these components allows us to assess regulatory capacity across jurisdictions, sectors, and time.

Regulatory expertise encompasses policy-makers' ability to identify regulatory challenges, develop policy solutions, implement them, and provide competent monitoring. At a minimum, developing an international regulatory strategy requires staff with sufficient training to identify areas of concern and to make policy demands on third countries. Comprehensive budgetary resources, years of experience, and a high level of professional staffing thus all demonstrate regulatory expertise (Gilardi 2002). Regulators with few internal resources and minimal staff find it difficult to formulate international initiatives and press their agenda against foreign jurisdictions. Those with substantial experience and staffing, by contrast, are likely to have the institutional knowledge and legitimacy to play the role of policy entrepreneur (Carpenter 2001).

Regulatory capacity also depends on the coherence of regulatory authority in a policy domain. All else being equal, the more coherent regulatory authority is,

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the easier it is to formulate externalization strategies and the more credible the commitment to monitoring and enforcement (Mattli and Büthe 2003). Countries have little incentive to adjust their domestic rules if regulators in leading markets cannot clearly articulate the demanded adjustment strategy. Regulatory capacity should be greater when regulatory authority has been delegated to a specific regulatory body that has the authority to shape and enforce market rules, and weaker when it is dispersed.

But regulatory expertise and coherence alone are insufficient if regulators lack the statutory authority to impose costs for non-compliance. Regulatory capacity also depends critically on the ability to punish non-adjustment. The extent of a regulator's statutory sanctioning authority is usually rooted in facilitating legislation for the particular domain. The most costly way to punish non-adjustment is to ban market entry, that is, to exclude firms that fail to meet required standards from the domestic market. Agencies may also have the authority to monetarily fine firms or exact reputational costs. Regulators that lack such powers have a diminished ability to export their domestic regulation because in the absence of coercive threats, foreign jurisdictions often have few incentives to adjust (Simmons 2001).

To summarize, jurisdictions with large markets rely on their institutional resources to make demands on foreign authorities. These, in turn, adjust when they perceive the cost of resisting as greater than the cost of adjustment. Regulators making international demands can punish resistance through penalties against foreign firms, such as reputational costs associated with condemnation, official regulatory fines, or exclusion from the domestic market. Market size is important because it determines the extent of *potential* costs to resisting regulatory demands. It does not determine the *actual* costs of non-adjustment, however, because the *probability* of suffering penalties has little to do with market size but rather with the credible threat of discovery and enforcement (North and Weingast 1989). Critical, then, in the influence equation is the foreign jurisdiction's perception of the demand-making regulator's ability to monitor and punish inaction, which is heavily influenced by regulatory capacity.

Given this conceptualization of regulatory capacity, we contend that Europe's ability to promote its preferred policies internationally depends centrally on its internal regulatory institutions. Obviously, factors such as political will limit the effects of regulatory capacity. But in cases where a jurisdiction has an interest in exporting its rules, we expect reforms aimed at strengthening domestic regulatory capacity to enhance a jurisdiction's ability to exert international regulatory influence. In Europe, this means that regulatory reforms on the member state and EU levels in recent years should have boosted Europe's ability to shape international regulation even though the primary objective of said reforms was to improve the functioning of the Single Market. Furthermore, it implies that Europe – and other large jurisdictions for that matter – could continue to grow their influence even as market size remains constant.

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THE REGULATORY STATE AT WORK ABROAD

To illustrate and evaluate the argument, we employ comparative historical analysis in two areas – data privacy and securities. Several reasons underpin this methodology and case selection. Since markets for personal data and financial instruments increasingly transcend borders, the chance of regulatory conflict is high and the two therefore represent ideal cases for an empirical evaluation (George and Bennett 2005). Additionally, over the 30-year period under investigation, the two cases exhibit significant variation across and within cases, strengthening confidence in the findings (Mahoney 2003). Finally, comparative historical analysis is particularly conducive to uncovering the mechanisms that link market size to international influence (Hall 2003). Throughout, we assess the institutional argument against a null hypothesis that attributes regulatory influence to market size alone.

EUROPEAN LEADERSHIP IN THE DIGITAL ECONOMY: THE CASE OF DATA PRIVACY

With the rise of technologies such as the Internet, personal data are digitally transmitted instantaneously across the globe at almost no cost. Companies and governments employ such data to segment markets and to manage risk. These efforts confront unique national data privacy regulations that have evolved over the past 30 years (Bennett 1992). In the 1970s, a group of European countries, including Germany and France, adopted comprehensive legislation that established privacy principles for the public and private sector enforced by independent regulatory agencies. Other countries, including the US, focused instead on public sector data, relegating private sector issues to industry self-regulation.

With the rapid diffusion of information technologies, rules governing personal data have become a contentious global political issue (Swire and Litan 1998). Europe has dominated the debate and has effectively promoted its comprehensive model. The 1995 EU Data Privacy Directive required all member states to adopt comprehensive legislation. In light of the growing cross-border flow of data, the directive also included an extra-territorial provision to limit the transfer of personal information from Europe to third countries with inadequate privacy protection (Simitis 1995). In total, over 30 countries from five continents have adopted EU-style rules (Council of Europe 2004).

Although the US has waged a vocal campaign against Europe's approach, it has failed to contain the spread of European rules. Seven countries – including leading economies such as Japan, Canada, and Australia – that previously shared the US approach have switched to Europe's comprehensive system. Europe even forced the US itself to make concessions. After a protracted debate, the two sides settled a dispute about the inadequacy of American rules through the adoption of the so-called Safe Harbor agreement. The agreement stipulates that US firms active in European markets abide by EU rules even

when data are processed in the US (Farrell 2003). While the US continues to stall on reforming domestic data privacy rules, European regulations have become the de facto international standard (Shaffer 2000).

Despite Europe's general dominance of international data privacy regulation, the US has had some recent success in the field of homeland security. In a well-publicized dispute, the US demanded that all international airlines provide the US Customs Office with detailed passenger records for flights into the US. This demand conflicted with European regulations. After several rounds of heated negotiations, the EU agreed to deliver some of the requested information (Moore and Nakashima 2006). While the final outcome of this dispute is still uncertain, as the original compromise was struck down by the European Court of Justice (ECJ), it is clear that in this field Europe, not the US, has been on the defensive.

Personal data regulation is strategically important in the information age, influences market dynamics across sectors, and has considerable distributional implications. A survey of leading US financial services companies suggests that the free flow of personal information earns that industry alone about $17 billion annually (Glassman 2000). Given the high stakes and the extent of America's global influence in the areas of information technology and electronic commerce, why has Europe been able to export its strict privacy rules? And why, after years of impotence in this domain, has the US challenged European rules in the specific case of airline passenger data?

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Second-class market . . .

It is near-universally accepted that Europe trails the US in the fields of e-commerce and information services. What is true today is even truer for the time between 1990 and 2000, a period marked by the onset of European regulatory export and the conclusion of the Safe Harbor agreement. Regardless of methodology, all estimates suggest that Europe lagged – and continues to lag – behind the US in international e-commerce (Uncapher 2000). To take just one example, Forrester estimates that global business-to-consumer (B2C) e-commerce revenue reached $657 million in 2000, with $480 million in the US compared to just $87 in Europe (Forrester Research 2000).

America's leadership in the area of e-commerce during the period under investigation held across markets and industries. In critical B2C segments, the online share of transactions in the US was around three times higher than in Europe. For our purposes, the area of financial brokerage is particularly interesting, as these transactions routinely involve sensitive personal information. In 1999, more than 15 per cent of all retail financial brokerage transactions in the US took place online. In Europe, the comparable figure was 5.5 per cent (Anonymous 2000).

Defying the expectations of existing literature, the EU privacy model spread internationally even though European markets were considerably smaller than America's. While Europe dominated privacy debates, the US successfully

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leveraged its market leadership in several key areas of e-commerce and Internet regulation, including intellectual property, taxation, trademarks, and domain names.[1] Additionally, the US' recent assertion of its interests in the dispute over airline passenger records cannot be explained by a shift in market size between the two regions. A focus on market size alone is therefore insufficient to account for observable patterns of international influence.

. . . With first-class regulatory institutions

Despite the limited size of Europe's digital markets, Europe has considerable regulatory capacity in the area of privacy and an extensive regulatory tradition. Following the passage of the first comprehensive privacy policy in Sweden in the early 1970s, various European countries created independent regulatory agencies with significant monitoring and enforcement powers. Buffered from direct political control, many European data privacy authorities are characterized by budgetary autonomy, technocratic expert leadership, and high levels of professional staffing. They have broad jurisdiction over issues concerning data privacy. While the exact statutory powers and procedures differ cross-nationally, these agencies have the authority to regulate the transfer of personal information to third countries, monitor and investigate complaints, review relevant legislation, leverage public opinion through the media, and punish non-compliance through administrative fines (Flaherty 1989). In short, they have substantial regulatory capacity.

The passage of the EU directive not only mandated strong data privacy regimes for all member states, but also created institutional mechanisms for intra-European co-ordination and external projection.[2] The directive explicitly granted European regulators statutory authority over market access. Regulators can block information flows from Europe to third countries that lack adequate privacy standards, thereby effectively excluding firms based in those countries from the European market for personal data-intensive services. To this end, the directive created a network of member state data privacy authorities – the Article 29 Group – that makes adequacy determinations of third-country legislation and advises on EU data policy (Swire and Litan 1998). So far, the group has declared the Swiss, Canadian, and Hungarian (pre-enlargement) systems as adequate, while rejecting the Australian system as too lax. At the same time, relying on their individual authorities, national data privacy agencies have fined companies that failed to meet European standards and have thereby affected interest group preferences and coalitions abroad.[3] By institutionalizing market access control at the EU level, the Privacy Directive has significantly augmented already considerable European regulatory capacity in this area.

Whereas European markets feature extensive regulatory capacity along all three dimensions – expertise, coherence, and statutory authority – US regulatory capacity is weak. The decision in the 1970s to forgo comprehensive privacy protection and not to create a regulatory agency has retarded the formation of regulatory expertise and has perpetuated fragmentation of US regulatory

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authority. On the federal level, the Federal Trade Commission, the Office of Management and Budget, the Department of Health and Human Services, and the Federal Communication Commission variably claim authority for privacy concerns. There is virtually no co-ordination among these agencies, severely limiting their influence in international debates. With respect to private sector monitoring, a multitude of self-regulatory organizations carry a large share of the burden. Relying primarily on reputation mechanisms – the granting and removing of privacy seals – self-regulatory bodies lack the sweeping market exclusion powers of European regulators.

Selective US pushback and European resistance

Given the US's limited influence in international privacy debates, its inroads in the field of airline passenger records are noteworthy and warrant explanation. While changes in market size cannot account for this shift, the inclusion of regulatory capacity provides a rather persuasive explanation. Generally lacking regulatory capacity in the privacy sphere, the US has tremendous capacity in the area of border control and air traffic regulation (Cowhey and Richards 2006). Homeland security legislation passed after the 9/11 terrorist attacks empowered US customs officials to block US-bound flights from countries that fail to comply with passenger data transfer requirements, effectively conferring market exclusion power. The Department of Homeland Security appointed a chief privacy officer in 2003 who is responsible for monitoring the privacy implications of US security policy. When US and European officials negotiated the issue of passenger information, the US thus brought a domestically empowered privacy expert to the table.

A recent decision by the ECJ, which held that the transfer of airline passenger information could not be negotiated under competencies delegated under the internal market framework, has further helped the US. The ECJ decided that the issue fell into the domain of home and justice affairs, an area where supranational European institutions are considerably weaker (Clark 2006). The decision thus curtailed the European Commission's ability to co-ordinate future negotiations. Despite the considerable US regulatory capacity in the area of homeland security and the weakened European capacity in this sub-domain, it is important to note that the US nevertheless made several concessions. The US initially demanded access to all passenger data, including sensitive information such as meal preferences which could indicate religious affiliation. EU privacy regulators strongly objected and ensured limitations on the type of data provided (Moore and Nakashima 2006).

Despite its relatively small share of global information markets, the EU – not the US – has set de facto international privacy standards. Already enjoying considerable regulatory capacity in the personal data field before the Internet revolution, European policy-makers augmented this capacity and gave European regulators tools to force foreign adjustment. While the size of its market may have helped the US to negotiate the Safe Harbor agreement – cutting off

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data flows to the US, after all, would have pained Europeans more than to, say, Chile – the US has not been able to prevent the global spread of European standards. The case of airline passenger data is an important counterpoint. Here, the US resisted European convergence pressure by leveraging its own considerable regulatory capacity in customs policy and homeland security.

FROM US DOMINANCE TO TRANSATLANTIC DIALOGUE: THE CASE OF SECURITIES REGULATION

Financial market regulation occupies a critical place in the fabric of global economic governance. Attracting capital and reducing the cost of financing for companies has become an important determinant of competitive advantage. Not surprisingly, the rules governing international financial markets have therefore become the subject of intense political debate. There is little disagreement that the US is home to the world's largest and most vibrant financial markets, and that US banks, brokerages, and securities firms have dominant international positions. Simmons (2001: 595) speaks for many when she concludes that 'the United States is hegemonic in finance in the sense that it is costlier to alter its preferred regulatory innovation than to try to change the policies of the rest of the world.' Given America's market hegemony, the case of securities regulation is a 'hard test' for our institutional argument stressing regulatory capacity.

US dominance

The US has been the international reference point for securities market regulation since the creation of the Securities and Exchange Commission (SEC) in 1934. Charged with investor protection and the maintenance of transparent and stable markets, the SEC took its domestic agenda international when financial globalization transformed regulatory differences across jurisdictions into pervasive arbitrage opportunities (Bach 2004). Through new legislation with extraterritorial reach, a series of bilateral co-operation agreements, and its leadership in the International Organization of Securities Commissions (IOSCO), the SEC deliberately exported much of America's securities regulation (Raustiala 2002). The case of insider trading is particularly telling. In 1980, the US was one of only 11 countries among the 67 with stock exchanges that banned insider trading. The UK, Japan, Hong Kong, and Germany were just some of the global financial centres lacking such rules. In sharp contrast, by 1998, 83 of now 97 countries with stock exchanges had outlawed insider trading. In less than two decades, insider trading regulation spread from just 16 per cent of markets to a remarkable 85 per cent (Bhattacharya and Daouk 2002).

During the 1980s and 1990s, the US not only shaped substantive rules, it also influenced the design of regulatory institutions around the world. Whereas a majority of securities markets two decades ago featured stock exchange self-regulation, central bank oversight, or regulation through finance ministries,

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the American model anchored on an independent regulatory agency has replaced institutional alternatives in virtually all major markets. Assessing regulatory reform in the UK, Japan, Germany, and Korea, Laurence (1999: 647) concludes that '[a]ll four new agencies resemble each other in several important respects, and all were modeled, at least in part, on the SEC.' He identifies this as part of a 'broad trend in which different countries are adopting American-style institutions of investor protection'. The US has actively supported this process. The SEC has undertaken extensive training of foreign regulators and has made access to certain institutional resources conditional on foreign regulators enjoying a high degree of political independence (Raustiala 2002).

In the debate over how to regulate globalizing securities markets European policy-makers repeatedly sought to advance their interests; yet they were frequently rebuffed by US opposition. Led by France and the UK, for instance, European officials wanted to establish harmonized capital adequacy standards for securities firms (MacRae 1990). Negotiations broke down in 1992, however, when the SEC vetoed European proposals (Waters 1993). European regulators similarly failed to convince the SEC to let European firms listed on American exchanges submit reports according to International Accounting Standards rather than US Generally Accepted Accounting Principles (US-GAAP). Throughout the 1980s and much of the 1990s, transatlantic relations in the area of securities were thus a one-way street: Europe adopted much of US regulation without securing adjustments on the other side.

European pushback and new transatlantic co-operation

Since then the situation has changed considerably. European regulators have made significant inroads and have forced their US counterparts to make important concessions in several areas (Posner 2004). The case of 'consolidated regulation' and the implementation of new US rules under the Sarbanes-Oxley Act illustrate the new dynamics.

In 2002, the EU adopted new rules mandating 'global consolidated supervision', meaning that a single regulator must oversee all operations of a financial conglomerate across different types of financial services and jurisdictions. Non-EU regulators can only serve in this capacity if their rules meet standards of equivalency. At the time, the US did not meet these standards and the SEC initially refused to adjust. Under pressure from internationally operating US financial firms and after a series of transatlantic consultations, however, the SEC began the process of substantially revising certain domestic rules to meet European standards.[4] To adapt US regulation to European demands, the SEC had to challenge the Federal Reserve Bank's role in the field of broker–dealer supervision, leading to considerable domestic conflict (Wighton 2004).

Europe also effectively resisted extraterritorial demands that emanated from new US legislation. Following the wave of corporate scandals that shook America, Congress enacted through the Sarbanes-Oxley Act stringent new

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obligations for publicly listed corporations and certifying accountants. The Act contained multiple provisions with extraterritorial reach that challenged core elements of European corporate governance and threatened to impose considerable costs on European firms. European officials pushed successfully for prolonged transition times and obtained key exemptions (Adrian 2003; Parker 2003).

Negotiations over both issues – financial conglomerates and Sarbanes-Oxley – have ushered in a new era of transatlantic co-operation as both sides vow to consult one another more frequently. 'We will not be in a situation where our international colleagues in Europe will be surprised again by regulatory activities,' declared SEC member Joel Campos after a meeting with European regulators (Norris 2004). This attitude is a remarkable change from just a few years earlier when American regulators, to paraphrase Simmons, found it easier to impose their preferences on the rest of the world than to even consult their European counterparts.

Market size, regulatory capacity, and Europe's new influence

In contrast to earlier US issue hegemony, American regulators have recently made important concessions to meet European demands. They have exempted European firms from extraterritorial US regulations and have in fact revised their own domestic rules to accommodate extraterritorial provisions of new European regulation. If US regulatory hegemony in the securities industry in the 1980s and much of the 1990s was simply a result of America's financial market dominance, a subsequent European catch-up might explain the current, more balanced situation. Indeed, European policy-makers had hoped that the introduction of the euro would foster market integration and thus boost Europe's international financial standing. Yet there is no evidence that Europe's common currency has challenged the dollar's pre-eminence, whether as reserve currency, denominator of critical commodities, or for securities underwriting (Cohen 2003). More importantly, and adding to the puzzle of growing European influence, longitudinal data on relative market size are inversely related to the patterns of international regulatory influence described above (see Figure 1).

Between 1983 and 1991, the period when US regulators began the conscious export of US securities market regulation, the size ratio of US and major European markets fell from almost five-to-one to less than two-to-one. During the period when European markets appeared closest to America's in terms of size – the early 1990s – the US frequently and effectively rebuffed European regulatory demands. With the market size ratio largely stabilized at the two-and-a-half mark since the end of the 1990s, nothing in the data would suggest growing European influence.

European securities markets have not matched America's in size, let alone surpassed them. What then explains growing European regulatory influence and the new transatlantic balance? The answer lies in the formation and

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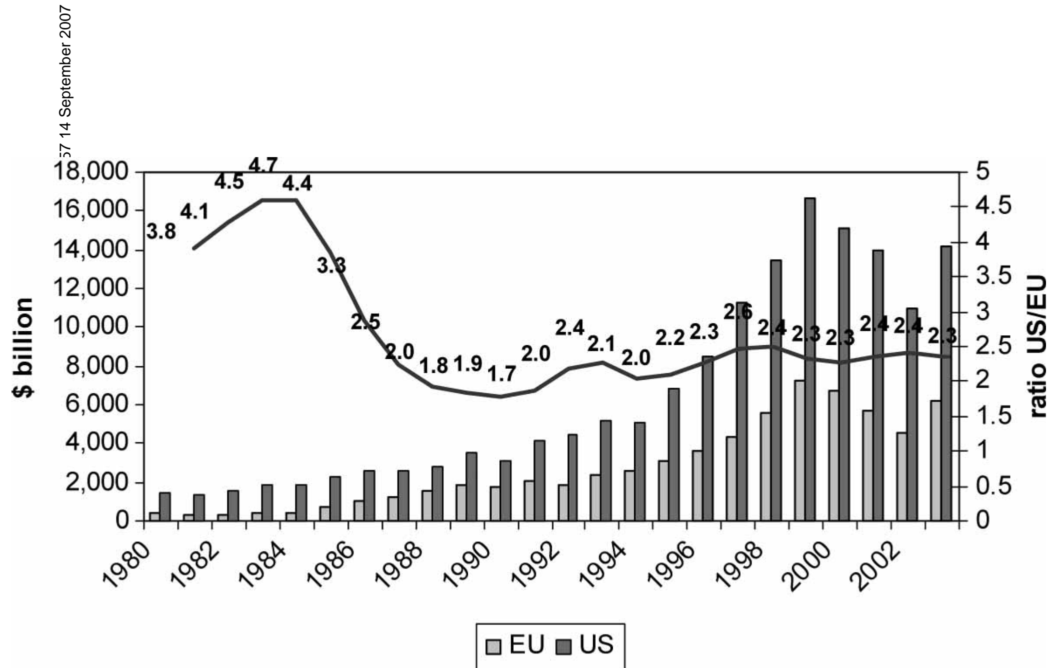

Figure 1 US and European securities market size, 1980–2003
Note: The first column for each year is the sum of market capitalizations in London, Paris, Frankfurt, Milan, and Amsterdam. The second column is the sum of the NYSE and NASDAQ. The curve is the two-year moving average ratio of the columns.
Source: Calculated from Securities Industry Association Fact Book, various issues.

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development of European regulatory capacity, a process that began 15 years ago and that has accelerated considerably since 2000. European countries did not command extensive regulatory capacity during the 1980s and into the 1990s (de Montricher 2005). In key markets, such as Germany and the UK, independent regulators did not exist or had just been created (Moran 1994). In several cases, stock exchanges or lower-level finance ministry officials represented European countries within international bodies such as IOSCO. Where independent regulators did exist, they often had few personnel, little expertise, and limited enforcement powers. Most importantly, there was scant co-ordination among European regulators. But a series of internal reforms has significantly boosted Europe's regulatory capacity (Posner 2004; Jabko 2006), enabling it to make demands on the US and to shape global public policy.

It was the very success of US regulatory exports that fuelled the growth of regulatory capacity in Europe. In the late 1980s, France and the UK began the process of leading Europe away from various forms of self- and ministerial regulation and toward regulation through SEC-style independent agencies (Moran 1994; Cerny 1989). The EU's Investment Services Directive later formalized the paradigm shift by requiring all member states to create independent regulators, a process completed with Germany's reforms in 1994 (Lütz 1998). These newly created regulatory agencies not only had considerably more power than their respective predecessors, including the ability to effectively control market access, they also quickly accumulated expert staff and thus significantly bolstered regulatory expertise.

In the middle of the 1990s, co-operation among these agencies intensified. Europe's new regulators first concluded a series of bilateral agreements amongst themselves and then adopted a multilateral one in 1997 to strengthen co-operation. They created the Forum of European Securities Commissions (FESCO) as Europe's IOSCO equivalent. Technically not an EU body, FESCO nevertheless became a critical mechanism for the co-ordination of European securities regulation and cross-border securities law enforcement.

Despite progress in the construction of European regulatory institutions for financial markets in the late 1990s, the European Commission pressed for further reform. A committee chaired by Alexandre Lamfalussy recommended sweeping changes, including the formal incorporation of FESCO into EU policy-making (Lamfalussy 2001). Renamed the Committee of European Securities Regulators (CESR), the group has been strengthened considerably and has become the central co-ordinator of Europe's securities regime. Recently enacted directives give CESR a formal role in determining whether foreign regulation meets European standards. The strengthening of regulatory capacity on the member state level, and the institutionalized co-ordination on the EU level, have enabled Europe to give American securities regulators a taste of their own medicine. New rules, for example, give European regulators the authority to exclude foreign firms – including US firms – from access to European markets if they do not abide by stringent European standards. When US regulators initially failed to respond to European concerns regarding

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Sarbanes-Oxley, EU regulators openly contemplated regulatory retaliation (Blum and Wright 2003). Indeed, some US officials viewed the EU's financial conglomerates directive and its tough equivalency tests as a deliberate bargaining chip and SEC chairman Harvey Pitt apparently contemplated a quid pro quo in which Europe would lighten the burden on US firms in exchange for more Sarbanes-Oxley exemptions (Guerrera 2002). That the mighty SEC would even consider such a deal is a testament of Europe's new-found ability to articulate and implement a coherent regulatory strategy and to back it up with the credible threat of market exclusion.

CONCLUSION

The globalization of markets is driving a parallel globalization of regulation. Many domestic public policy debates increasingly unfold across borders. This article has focused on Europe's growing clout in global market governance to show that market size alone is insufficient as a determinant of regulatory influence. A sizeable market must be coupled with powerful and capable regulatory institutions. Findings from two case studies broadly support this claim. They also reveal that the argument applies beyond Europe. US influence in the securities field has its roots in the combination of extensive regulatory capacity and the world's largest and most attractive securities market. Likewise, recent US inroads in the field of airline passenger data are rooted in potent institutions in this domain. The study thus suggests more generally that influence over global market rules stems from regulatory institutions that can activate latent power vested in sizeable domestic markets.

The argument presented is consistent with a growing body of literature that examines the importance of domestic institutions for EU external relations (Meunier 2005; Smith 2004). While much of the existing literature on the topic focuses on conventional fields of foreign economic relations such as trade policy, we argue that much of Europe's new-found influence has emerged unintentionally through regulatory reforms in response to internal challenges. The article thus extends the findings of complementary work in the area of private-sector rule-making to broader debates about the external implications of the regulatory state (Mattli and Büthe 2003).

Future research should expand the analytic scope beyond the cases and markets considered in this study. Initial investigations suggest that parallel institutional reforms underway in Asia are beginning to affect international market regulation, in much the same way as Europe's have over the last few years (Bach *et al.* 2006). Building on these qualitative findings, it would be desirable to derive basic quantitative measures of different dimensions of regulatory capacity to permit larger-N evaluations of the argument. Boundary conditions and possible interaction effects could thereby be established. In this context, further work should also examine the interaction of regulatory capacity with preferences and preference formation.

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Even at this preliminary stage, the findings make an important contribution. They offer a corrective to a singular focus on market size and provide compelling mechanisms linking sizeable markets and domestic institutions to international regulatory influence. The study also underscores the benefits of transcending the divide between comparative and international political economy. Many insights from work on comparative political economy and public policy bear directly on current international dynamics. As markets and policy processes transcend boundaries, it is important for research to follow suit.

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NOTES

1 These are all cases where the US – in contrast to the field of personal data – possessed or has created considerable regulatory capacity. See Bach (2004).
2 For a political history of the directive, see Newman (forthcoming).
3 'Microsoft signs Safe Harbor following fine', *Precision Marketing*, 18 May 2001, P. 1.
4 'Supervisors wanted', *Financial Times*, 27 October 2003, p. 22, and 'Banks pressure SEC to become super-regulator', *eFinancialNews.com*, 24 January 2004.

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