Regulation, Markets and Poverty

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1. Introduction

For more than 25 years, developing countries in Africa, Asia and Latin America have been pursuing, in various ways and with varying degrees of intensity, economic liberalization. For many of them this took place under externally driven programmes of structural adjustment, in which the World Bank and the International Monetary Fund (IMF) directed governments in implementing fiscal and exchange rate reform, trade liberalization, domestic market liberalization and privatization.

Countries undergoing structural adjustment did not initially recognize how important regulation is for economic liberalization. Indeed, regulatory and competition policy was conspicuously absent from the policies prescribed by the World Bank and the IMF. Initially, privatization was often pursued without much thought to the regulatory framework that would be needed, even where state-owned monopoly utilities had been converted to private sector monopolies (Cook et al., 2004a). There were only a handful of developing countries that had competition agencies, even in the limited anti-trust sense, by the end of the 1980s (Gray and Davies, 1993).

With the spread of economic liberalization across the world and the underlying structural changes that were taking place within economies, it became increasingly obvious that attention needed to be paid to regulation and competition. Without regulation the potential advantages of liberalizing markets were in danger of being diminished, both in terms of improved efficiency and welfare. Even in developed countries that had embarked on various market-oriented reforms within government, and had privatized utilities and outsourced numerous public services, it became evident that there was a lack of public accountability and that new forms of regulation were needed to monitor market abuse and protect consumers. In developing countries the scope of regulation and competition policy needed was wider because of the urgent social and economic problems they faced. If regulation restricted itself only to ensuring efficiency and competition in the private sector, it would be unlikely to have a direct positive impact on the poor.

As a consequence new forms of regulation have been emerging that cover health, environment, industry, employment and so on. In particular, in recent years there has been considerable interest in the regulation of privatized industries in the fields of telecommunications, energy, transport and water. The expected benefits of privatization in these fields were predicated on the existence of a well-functioning market process. However, in practice, privatization has often resulted in monopoly and regulation has been needed in order to protect consumers from potential monopoly abuse. To meet this challenge new dedicated industry regulators have been established, bringing with them new and innovative methods for regulation that attempt to improve efficiency and safeguard consumer welfare.

Although competition had previously been neglected, recent years have seen a new impetus to promote competition policy, largely in the anti-trust tradition. The introduction of new and in some cases revised competition law, and the establishment of competition agencies to monitor and enforce legislation and act as advocates for the merits of competition, has become a prominent feature of most countries' reform agendas.

Judging how effective these changes have been depends as much on understanding the premises on which they have been based, as on finding ways to test their outcomes empirically. Our research has attempted to do both. We have examined the concepts and theories that have driven reforms and the particular contexts that have influenced and conditioned them. And we have used various approaches, both quantitative and qualitative, to investigate how well reforms have worked in practice.

The notion of competition is central to economic theory. But there are widely differing views as to what it means and how it works and contributes to development. The concept of 'perfect competition' has survived as a standard model for analysis and has profoundly influenced policy-makers concerned with the regulation of competition. This neo-classical perspective on competition is built around the notion that the ideal market is best understood as a state of equilibrium created by forces of demand and cost structures that primarily determine which enterprises survive or fail. In other words, the emphasis has been on the effects or end results of competition rather than on the underlying behaviours that characterize the competitive process.

This view of competition has not gone unchallenged. A variety of alternative perspectives express their fundamental dissatisfaction with the equilibrium concept of competition. Drawing on Schumpeter's analysis (Schumpeter, 1934, p. 17), these alternative perspectives largely reflect the view that competition cannot be perceived in terms of a state of equilibrium, characterized by different market structures such as monopoly and perfect competition. Instead, the organizing concepts of equilibrium and optimization evident in the neo-classical approach are rejected in favour of viewing competition as a process of change caused by the different ways that enterprises behave. This alternative way of understanding competition has different implications for policy, which are explored in later chapters of the book.

We distinguish between various types of regulation. One is the regulation of businesses, that is, controls over private and non-state activities. Another is regulation inside government, that is, the controls exerted within and between government agencies, and between levels of national government. International regulation also exists (the regulation of national governments by supranational organizations), as does self-regulation, which involves less formal methods than legislative or administrative rule-making. These various aspects of regulation and the corresponding policy implications are also the subject matter of later chapters.

Our research demonstrates that the analysis of competition and regulation must extend beyond their economic principles. Not only are ideological issues involved in competing views on the best or most appropriate relationship between the state and the market process, but it is also clear that regulatory and competition policies emerge from political and bureaucratic processes that are influenced by a wide range of factors. Therefore we assert the importance of legal and political analysis. Regulation in all its guises is fundamentally concerned with rules governing the actions and relationships between agents, and it is the law that has traditionally policed these boundaries and resolved disputes. In turn, regulatory institutions and their practice have been shaped by, and evolved from, a whole range of governance factors. These include the variety of government institutions involved in rule-making and implementation, public policy processes, the significance of political interactions and relationships, and last but not least, the systems of public values that provide the underlying setting for regulation and competition.

The research that has been undertaken by the Centre on Regulation and Competition that has led to this book has reflected our desire to examine critically the new wave of approaches to regulation and competition. It is clear from the research embodied in the various chapters of the book that models of regulation and competition derived from developed country practice have predominantly been rooted in sophisticated levels of economic, social, administrative, legal and political institutionalization, which are largely absent or less developed in developing countries. When working out new forms of regulation and competition policy there is a need to ground them in the economic, political and administrative realities that exist in the country concerned, since a naive transfer of models will merely provide new opportunities for inefficiency, patronage, clientelism and corruption (Cook and Minogue, 2003).

The research that forms the backbone of this book has also tried to address issues of regulation and competition in the context of poverty in developing countries. We argue that better regulation and competition play an important part in improving both the performance of enterprises and the delivery of essential services, and that these are integrally related to a pro-poor development process. Addressing poverty, in its absolute and relative forms, has been an important aim for us.

Our research into the connection between regulation, competition and poverty has focused on how regulation and competition policies can impact on poor people. For example, we ask whether or not regulation can help the poorer in society access essential services and infrastructure such as water. Potentially, regulation and competition could help such people not just by protecting their welfare but also by promoting it through providing opportunities to engage in productive activities in ways that will make them better off. But it is important to realize that this is far from guaranteed. The effects of regulation and competition may simply bypass the poor or indeed make their situation even worse. The potential welfare effects of regulation and competition are not confined to poverty reduction alone, but also relate to more general distributional issues. Better regulation and more competitive markets might also contribute to reducing the high levels of income inequality found in a significant number of developing countries.

Our research also recognizes the importance of focusing attention on the *capacity* to regulate. It is not enough to just develop models and instruments for regulation, particularly when regulatory and competition agencies are new and set in political and administrative systems with weak governance mechanisms. It is also necessary to consider the human and managerial attributes that shape those organizations, determine whether or not they are likely to be effective and take appropriate action. A failure to address capacity building is likely to have widespread repercussions.

The final motivation for this book has been our desire to make the fruits of five years of research in the Centre on Regulation and Competition available to a wider audience. We have already published three academic books detailing this research and anticipate publishing a further four. But we believe the implications of our work are too important to be restricted to that necessarily small, specialist audience that is willing and able to wade through large quantities of detailed econometric and other analysis. For this reason Sarah Mosedale wrote a series of Policy Briefs drawing on the Centre's research, which tried to make our ideas, arguments and conclusions available to the much larger audience that we knew was interested in, and we hoped might benefit from, our work. The positive response these received encouraged us to believe that a book organized along the same lines would also be welcomed. The result is what you now hold in your hands.

Following the introduction, the book is organized into five parts. The first part, comprising three chapters, deals with competition and competition policy. These chapters are based primarily on research in these areas by Paul Cook and Yuichiro Uchida, John Stanley Metcalfe and Ronnie Ramlogan, Cassey Lee, Jeffrey Henderson and Richard Phillips. Chapter 2, based on studies by Paul Cook and Yuichiro Uchida and John Stanley Metcalfe and Ronnie Ramlogan, argues for a more critical look at competition, both in terms of defining what it means for the notion of development as a whole and what viewing competition in different ways implies for policy. This chapter emphasizes that economic change depends on the competitive process in which enterprises are displaced, replaced and self-transformed as they grow at different rates. At the heart of this transformation is innovation that depends critically on the institutions of the market. But if markets are to generate innovation, then innovation systems are needed that connect enterprises with other knowledge-holding and -generating organizations.

Chapter 3, based on research by Paul Cook, Cassey Lee, Germano Mendes de Paula, Efa Yonnedi and Trudi Hartzenberg, concentrates on the design of competition, particularly recognizing the need to stimulate, not inhibit, the innovative process. This chapter highlights the complexity of designing and implementing competition policy. An example drawn from Brazil indicates that a sophisticated competition policy can be hampered by a weak legal infrastructure. An example from South Africa reveals the difficulties encountered when trying to incorporate numerous objectives into competition policy.

Chapter 4, based on the work of Paul Cook, Yuichiro Uchida, Jeffrey Henderson, Richard Phillips, John Stanley Metcalfe and Ronnie Ramlogan, highlights the importance of innovation for international competitiveness. Changes in patterns of technological and trade competitiveness are empirically examined among developed and developing economies. Results suggests that export performance strongly influences technological competitiveness, and as a result, the catching up process. It is also the case that the development of domestic competition plays an important part in this process of catching up. However, as the example for Malaysia emphasizes, external factors beyond the control of any individual country or enterprise do affect the ability of enterprises to compete effectively in international markets.

Part II of the book considers the issues of regulatory governance and regulatory transfer. Chapter 5 draws on research by Martin Minogue, Anthony Ogus, David Levi-Faur and Jacint Jordana and sets the framework for the analysis of regulation in the rest of the book. In this chapter the rise of the regulatory state is discussed and the characteristics of a regulatory system are outlined. The advantages and disadvantages of central versus locally organized regulation are discussed and we ask how effectively regulatory rules can be implemented in developing countries. Implementation is affected by the design of the rules, the models adopted and the regulatory governance framework. The latter is particularly unsophisticated in many developing countries and also considerably weakened by corruption. The argument put forward in this chapter is that, where corruption is deeply embedded in social behaviour, it may be more effective to focus on reducing opportunities for corruption rather than attempting to enforce anti-corruption measures.

In Chapter 6, issues of regulatory policy transfer are reviewed. This chapter draws on research by Martin Minogue, David Levi-Faur and Malathy Knight-John on the politics of regulation and Anthony Ogus and Qing Zhang on legal cultures and business licensing practice. An important point made is that regulation cannot be separated from politics, indeed the two are intertwined in an interactive process. The evolution of business licensing practice, particularly in China, Kenya and the United Kingdom, is used to illustrate the ways in which different legal systems and governance systems influence the type of reforms that are introduced.

Part III of the book concentrates on aspects of utility regulation. Chapter 7 draws on the research of Colin Kirkpatrick, David Parker and Yin-Fang Zhang to identify the critical issues in regulating utilities in developing countries. This research provides empirical evidence on the types of regulatory instruments used and whether or not regulation and competition are more effective than ownership changes in improving the performance of utilities. The chapter highlights two particular problems associated with utility regulation: hold-up and information asymmetries. Hold-up occurs when investment in infrastructure is made, often involving large sunk costs, which provides opportunities for opportunism or gaming by regulators and firms once contracts have been negotiated. The effectiveness of regulation is also impaired by failures to obtain adequate information. This chapter also emphasizes the importance of introducing competition when reforming public utilities. Finally, it reports the findings of research into the methods used in regulating utilities and the difficulties regulators encounter when implementing various forms of price and profit regulation.

Chapter 8 draws on research by Colin Kirkpatrick, David Parker and Yin-Fang Zhang and Paul Cook and Yuichiro Uchida. This chapter examines the performance of utilities in a wide range of developing countries. Overall performance, measured in terms of operational and financial variables, has declined for many utilities since privatization. This reverses some of the findings of previous research and dampens earlier optimism concerning post-privatization performance. The chapter goes on to report the findings of econometric analysis. First we investigate the relationship between regulation and direct foreign investment in the infrastructure sector in developing countries. It appears that the quality of regulation influences the flow of direct foreign investment. Second, we investigate the sequencing of economic reforms. The findings reported in this chapter support the view that the sequencing of competition, regulation and privatization matters. We found that utilities tend to perform better when the first two elements precede the latter.

Chapter 9 deals with ethical trade initiatives – a new and rapidly growing method of regulation. This chapter draws on the research of Richard Heeks, Richard Duncombe and Ledivina Cariño. It examines the indirect and direct regulatory mechanisms used in ethical trade and emphasizes the importance of information in each. The chapter also proposes a framework for assessing the performance of ethical trade regulatory systems and concludes that, when properly designed, they can deliver significant benefits.

Chapter 10, the final chapter in Part III of the book, deals with regulatory impact assessment (RIA). This chapter draws on research conducted principally by Colin Kirkpatrick, David Parker and Yin-Fang Zhang. It describes how RIA can be used both as an aid to designing new regulation, by assessing its likely impacts, and also to improve the quality of existing regulation, by assessing what its actual impacts have been. We outline the findings of empirical research conducted in a wide range of developing and transitional economies, which assesses how widely RIA has been used and how it has been conducted. Although we found marked regional differences in awareness and implementation of RIA, in general, the level of awareness and the application of RIA was higher than we originally anticipated. Unsurprisingly though, even in countries where RIA has been adopted in a manner consistent with OECD principles, there is evidence of inappropriate policy transfer, echoing some of the reservations made in Chapter 6.

Part IV of the book discusses the need for capacity building when dealing with regulation and competition policy. Chapters 11 and 12 have been written by Derek Eldridge and Brian Goulden and draw primarily on their research and that of other colleagues in CRC, in particular, Malathy Knight-John. Chapter 11 stresses the need to move away from a prescriptive approach towards one focusing on capacity building. An alternative approach is proposed that uses two diagnostic models, elaborated through research, to develop 'good partnership' in capacity building. The approach outlined has been designed to help regulators answer critical questions in pursuit of developing and improving regulation. Several case studies are used to illustrate how the approach can be adopted. Chapter 12 extends the analysis by focusing on the critical skills that need to be acquired to manage regulatory agencies effectively. In this chapter the tools for capacity building have been designed to support the strategic-level diagnostic models outlined in the previous chapter. These techniques and tools are used in a learning framework that covers the needs of new staff in regulatory agencies, their training in core areas of regulation and their continuous learning as a basis for career and professional development.

The final part of the book, consisting of two chapters, addresses issues of regulation and competition in relation to poverty. Chapter 13 draws on the research of Diana Mitlin, Julia Brown, Cassey Lee and Raul Fabella. This chapter looks at how pro-market reforms in the water sector have affected the poor and highlights the continuing importance of subsidies in the water sector even after privatization. Various approaches to subsidies are described and analysed in terms of their efficiency and the ways in which they have improved (or not) poor people's access to water services. Examples drawn from South Africa and the Philippines are used to illustrate the ways in which the poor have been affected by various market-enabled reforms to the water sector.

The final chapter of the book examines the connection between competition, regulation and poverty and includes research conducted by Paul Cook, Yuichiro Uchida, Martin Minogue, Colin Kirkpatrick, David Parker and Catarina Figueira. This chapter discusses what is meant by poverty, how it is measured and the main policy responses to tackling it, which include promoting livelihoods by expanding economic opportunities and protecting livelihoods by ensuring the poor have access to essential resources and services. We investigate the role that regulation and competition policies play with respect to these two approaches. In terms of promoting livelihoods we report on empirical investigations into how structural change (which was emphasized in Part I of the book) affects income inequality in developing countries. Importantly, this research indicates that improved competition in medium-level technology industries could potentially reduce the large inequalities in income in developing countries.

In terms of protecting livelihoods, we consider how access to essential services for the poor can be improved. This therefore links closely to the ideas developed in the previous chapter. It is argued that the development of infrastructure services (power, water, telecommunication and transport) contributes to both livelihood promotion and protection and to economic growth. Whether the privatization of infrastructure has benefited the poor is harder to answer since existing research is both scarce and inconclusive. What this chapter and Chapters 7 and 8 clearly indicate is that privatization alone is unlikely either to improve the performance of utilities significantly in the longer term or to improve access and affordability for the poor without accompanying competition and regulation and better developed subsidy schemes.