1. Competition, regulation and regulatory governance: an overview

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INTRODUCTION

Recent years have seen a movement away from state ownership towards more reliance on private markets to supply goods and services, including goods and services traditionally supplied by the state, such as telecommunications, water and electricity. These markets can be competitive, highly oligopolistic or even monopolistic. Where privatisation is associated with the creation of private monopoly then some form of continued state regulation is required to protect consumers from monopoly abuse. In cases where markets are oligopolistic or even competitive, state regulation may still be necessary to prevent the abuse of a dominant position, the creation of cartels, and in other ways to protect consumers through developing an effective 'competition policy'. Moreover, state regulation is also adopted internationally to protect society in the form of the regulation of working conditions, product quality, the environment, health and safety and the like. Indeed, in North America and the EU the regulation of markets has expanded at the same time as industries have been privatised (Blundell and Robinson, 2000). Therefore, contrary to the ambitions of leading advocates of 'privatisation', such as Milton Friedman in economics and Margaret Thatcher in politics, the 'frontiers of the state' have not been so much 'rolled back', but have been reshaped and redirected since the 1970s. This is evidenced, for example, in the shares of gross domestic product (GDP) controlled by the state in OECD countries, which have remained fairly stable.

The picture is much the same in many developing economies. Although 80 per cent of low-income countries are reported to have had some form of private participation in at least one infrastructure sector (Izaguirre and Rao, 2000), the scale of privatisation in many low-income economies has been very limited, especially outside of Latin America. In many countries privatisation seems to have been more talked about than carried out (e.g. Cook and Minogue, 1990; Parker, 2003). Only in the transition economies of Central and Eastern Europe and to a lesser degree China was there evidence of a substantial change in the

extent of state involvement in the economy. But these countries are atypical, in the sense that before the late 1980s governments dominated the ownership of industry and commerce to a degree not found elsewhere. Also, in these countries (excluding China) privatisation and deregulation had an overriding political imperative; reform was driven by the desire to prevent the restoration of communism.

The shift in public policy over the last two decades away from state ownership and state responsibility for the provision of services, to private ownership and private provision with enhanced state regulation, is sometimes described as the rise of the 'regulatory state' (Majone, 1997). Alternatively, it has been referred to in terms of the 'invisible hand' of the market being supplemented by the 'visible hand' of regulators (Jackson and Price, 1994). In this regime the state ceases to be directly concerned with the provision of goods and services and instead concentrates on regulating private markets to promote economic and social welfare. This book is concerned with the regulatory state and in the context specifically of developing countries. Whereas there are now many publications on privatisation and regulation in developed economies and a growing number of studies of privatisation in lower income economies, for lower income countries the inter-related nature of competition, regulation and regulatory governance remains relatively under-explored. This book is intended to help fill this gap.

In this introductory chapter we set the scene by detailing the main research issues in competition, regulation and regulatory governance. We then provide a summary of the content of each of the following chapters, highlighting their contribution to addressing these research issues.

COMPETITION

The emphasis on the need to develop the private sector in developing economies has largely been predicated on the assumption, most often unstated, that privately owned enterprises operate under competitive market conditions. This could be seen in the lack of explicit attention being given to competition policy, in its antitrust form, to accompany the earlier shift towards private sector development in general. Further, if competitive conditions were absent then the presumption was that processes of privatisation and liberalisation would create the conditions in which competition between enterprises would flourish. And where privatisation was undertaken in some sectors such as utilities with no, or at best a marginal increase in competition, then some dedicated form of sector regulation would act as a surrogate for competition, even if temporarily. Competition policy is now rapidly being adopted in a whole range of developing economies with the encouragement of the international

development institutions, and is an endorsement of the vital role that competition plays in the process of development.

Despite the centrality of the notion of competition in economic theory and its practice, its meaning and the ways in which it is perceived to work and contribute to development differ widely among theorists, policy-makers, bureaucrats and business people. Indeed, the history of economic thought provides some deeply contrasting views about the meaning of competition. These competing views of competition, in turn, have profound implications for the ways in which enterprises in the public and private sectors are perceived to contribute to development, and for the development of public policy approaches towards them.

For the classical economists writing in the nineteenth century, such as Adam Smith, competition was a process of rivalry between participants in the market who would compete by changing prices in response to market conditions, thereby eliminating excessive profits and unsatisfied demand. By the late nineteenth century the analytical development of the concept of competition had moved away from a behavioural approach to one that emphasised the importance of different market structures, and in which the organising concepts of the market relied on equilibrium and optimisation. This neoclassical approach generated the view that a market could be defined as competitive when there was a significantly large number of sellers of a homogeneous product, so that no sellers had enough of a market share to enable them to influence the product price by changing the quantity that they put onto the market. This idea was formally expressed in the notion of perfect competition, which has survived as the standard model for analysis and has ever since had a profound influence on policy-making concerned with the regulation of competition.

The classical and neoclassical concepts of competition differ, therefore, in their view of what competing means. The classical economists related the concept to business behaviour while the neoclassical view is more concerned with market structure. As Knight states 'perfect competition involves no presumption of psychological competition, emulation or rivalry' (Knight, 1946, p. 102).

The emphasis on market structure led to the development of the structure, conduct, performance approach to industrial organisation that has had such a significant influence on current-day thinking towards competition policy. In this approach it is argued that the performance of an industry, largely measured in terms of profitability, varies with market structure, which in turn influences enterprise behaviour. In this way, as with the process of 'getting prices right' under orthodox liberalisation programmes in order to maximise producer and consumer surpluses, 'getting the market structure right' by reducing levels of market concentration, will influence the behaviour of enterprises and prevent abuses from monopoly.

By contrast, the Chicago School of antitrust, as it has become known, drawing on the works of Alchian (1950), Peltzman (1976), Stigler (1971) and Posner (1974), and reflecting the influence of the Austrian School, challenges the notion that market behaviour performance is related strictly to market power. In their view, competition is a process that can lead to a variety of market structures providing efficient outcomes. They do not assume a constant state of market equilibrium, although competition can be expected to return the system to something resembling competitive equilibrium due to conditions of entry in the long run. Competition policy ought, therefore, to be directed predominantly towards removing regulatory barriers to entry. In contrast to static equilibrium theory and the market structure approach to competition policy, profits earned by successful entrepreneurs are not necessarily viewed as a sign of market inefficiency, but as a signal that entrepreneurs are responding to changing market conditions.

Apart from the convergence to a long run competitive equilibrium, this view of competition as a process is shared by the Evolutionary School of economics drawing on the works of Schumpeter. In particular, evolutionary theory is concerned with why the world changes endogenously, and with why technological competition is the driving force behind structural change and economic development (Metcalfe, 2000). Rather than the concern for profits, according to evolutionary economists the real cost of monopoly and collusive behaviour takes the form of stifling innovative effort and the long run competitive process by erecting barriers to challenging established market positions (Metcalfe et al., 2002).

Both the Chicago and the Evolutionary schools are sceptical about the performance, conduct, structure approach to competition policy. The Chicago School views the market structure approach, which emphasises the importance of market shares, as an inefficient policy that can lead to worsening market performance due to regulatory inefficiencies and regulatory capture (Stigler, 1971). In their view antitrust intervention is likely to be invoked by losers who allege unfair competition. The Evolutionary School believes there is an immense difference between competition policy as a negative discipline on enterprises, which sets out to break up market concentration and deviant behaviour as typified in conventional approaches to competition policy, compared with one that provides for positive incentives through the creation of better business opportunities. In the view of evolutionary economics, the search for an appropriate competition policy, particularly in economies where market institutions are underdeveloped, extends beyond measuring market power or excessive profits – it embraces the broader concerns of science and technology policy, and policy towards enterprise and innovation.

The discussion so far has directly and indirectly raised two key issues relating to the development of competition policy in developing economies. First,

what might be included in competition policy and at what cost? Should it focus on rules and procedures to prevent enterprises from engaging in anti-competitive behaviour? Should it be primarily aimed at reducing the barriers to entry and exit and facilitating the conditions under which enterprises can compete? Will it be effective in meeting its objectives? How is general competition policy related to other government policies that have implications for competitiveness, and to the conduct of sector regulation in particular? Second, how will the framework that is developed for domestic competition policy be shaped and impacted upon by global rules for competition?

In relation to the first question, the debate has concerned the division between a behavioural and a market structure approach to competition, as well as the need to consider a wider range of factors other than those incorporated in an antitrust approach to competition policy. An argument for a market structure approach, which tends to be more rules oriented and more mechanistically applied, is that this suits the developing economy context in which market institutions and the capacity and skills to implement policy are poorly developed. This mitigates against a behavioural approach, which is more skill intensive and potentially more costly to implement. This need for simple, mechanistic rules is reinforced by arguments that the transactions costs of collusion are lower in developing economies, simply because monitoring technologies are less efficient, and enterprises have lower risk aversion and little to lose from colluding (Rey, 1997).

All of this should be viewed in the context of competition not being the automatic outcome of privatisation and deregulation in developing countries. This means that simply conditioning international development loans on the existence of privatisation and market liberalisation policies, or even on the creation of a competition law, will not ensure the creation of proper institutions for effective competition. This may require new institutions that are costly to establish. The budgetary constraints facing low-income economies may inhibit the speed with which complex regulation and new institutions can be introduced. Also, the danger in pursuing a rules-based market structure approach to competition policy, as opposed to a behavioural one, is that by overly relying on simplistic measures of market power there is a risk that enterprises are unjustifiably penalised if market shares do not adequately capture or measure anti-competitive behaviour (Cook, 2002).

The recommendations of the Chicago School that entry barriers be removed may also be problematic in developing economies where government-erected barriers have been most persistent. In such cases regulatory capture may not simply be a case of capture by powerful domestic private interests, who argue for the competition authorities to keep out new entrants by alleging unfair competition, but capture by government itself. The aims and pursuits of government may, therefore, conflict with competition policy. The

conflict, however, may not necessarily be for the wrong reasons. Development policy may entail some degree of subsidy or protection to promote enterprises. The strategy of a sector regulator to expand a network activity (i.e. a developmental regulatory role) may on the surface appear as lax regulation, and one that conflicts with the introduction of more competition in terms of more market participants, but here, what is viewed as lax regulation may involve a legitimate trade-off between investment for the future and longer-term efficiency gains for the economy, and a current, static economic efficiency outcome.

The question of how international rules for competition are likely to affect domestic policy regimes is, of course, dependent on how far international rules are developed. There is mounting evidence that cross-border cartel activity has increased in recent years and is not being policed by international agencies (Evenett et al., 2001). One of the main arguments for international intervention is that anti-competitive practices in one area have spillover effects in others, as for example with import and export cartels and mergers involving foreign companies, and that domestic competition authorities are powerless to take action against them. Further, it seems that most host country competition authorities are unwilling to do so. Developing economy governments may have competition laws in place but be unable to gain evidence that anti-competitive practices are being undertaken. One result is the need for greater cooperation between competition authorities across countries. However, this policy outcome is constrained by the fact that at the present time the competition authorities in developed economies take into consideration the effects on their economies of anti-competitive actions worldwide, but do not specifically consider the effects of anti-competitive behaviour in their own countries on the developing world's economies (Holmes, 2003).

REGULATION

Regulation by the state can take many forms, from regulating employment terms, to health and safety legislation, to food safety, to regulating the environment, to regulating specific industries, and so on. In recent years with the privatisation of industries previously owned by the state in which competition is limited or absent, such as electricity, telecommunications, postal services, railways and water, regulation at industry level has increased. Sometimes this regulation has continued to be conducted from within government departments, but in other cases new, dedicated industry regulators have been created. Whatever the precise structure of the regulation adopted, however, all regulatory bodies face two fundamental challenges. The first of these relates to obtaining the necessary information to regulate effectively. Regulators need to

have access to reasonably accurate information on the costs and revenues of the regulated firms, their capital investments, consumer demand and the costs of raising capital. In addition, they must anticipate changes in the market environment including macroeconomic events that might impact on the regulated firm, both adversely and positively. Inevitably, the information regulators receive will tend to be incomplete. Whereas the regulated firm presumably has insider knowledge of its operating environment, the regulator lacks this, leading to what is referred to in the economics of regulation literature as the problem of 'information asymmetry'.

The second challenge to effective state regulation relates to incentives. In principle, governments will have better information to regulate effectively and efficiently when they directly control or own the regulated business than when they are regulating private producers (Shapiro and Willig, 1990). This is a long-standing argument for state ownership and implies that state ownership is superior to private ownership with state regulation. But in practice state ownership is associated with major inefficiencies in the use of resources (Martin and Parker, 1997, Ch. 4). This inferiority of performance under state ownership relates to the relative incentives under private and state ownership for managers to manage their businesses efficiently and to the incentives that government as regulator faces in regulating effectively. Under state ownership the government is both the owner and the regulator of assets, leading to a potential conflict of interest. For example, government may have an incentive to overlook environmental damage caused by a state-owned water company because challenging the company to make improvements, by for instance introducing new water treatment processes, might lead to higher water charges or necessitate subsidies out of taxation. Either way costs will fall on consumers/taxpayers, for which government will get the blame. Also, some regulatory interventions may have an adverse impact on employment in the industry, leading to the wrath of the unions. The general result is an incentive for politicians and their officials to overlook regulatory infringements, especially those that are costly or politically controversial. In other words, state ownership is associated with disincentives to regulate effectively. More generally, politicians are accused of regulating for short-term political gain, leading to a reduction in the economic benefits from regulation and increasing the long-term economic costs.

Traditionally governments have regulated for a range of reasons. A number of these reasons are grouped together under the heading of 'market failure'. But as will be emphasised, state regulation may be used for other purposes that are more closely related to the workings of the political process, and in reality these may conflict with an analysis of market failure. These other reasons are usually summarised under the headings of 'regulatory capture' and 'political capture'.

Market failure exists when the market is unable to produce an outcome that maximises economic welfare. In competitive markets without such failings, consumers maximise their welfare or 'consumer surplus' given the competitive price. Consumers freely participate in the market and, under admittedly a very restrictive set of assumptions, the result can be shown to be Pareto optimal. A Pareto optimal outcome is one in which there is no possibility of making anyone else better off without making someone else worse off. Hence, no further resource reallocation would improve economic welfare. This condition and its assumptions are well drilled into economics students and the result is a situation where no regulatory intervention by the state could raise economic welfare. However, in practice the restrictive assumptions on intertemporal competitiveness required for a Pareto optimum are not met and markets can and do fail to maximise economic welfare. The following are the well-rehearsed reasons for market failure.

- There are information deficiencies or asymmetries in the market so that consumers and producers are unable to make decisions optimally in order to maximise their welfare. Information asymmetry is said to exist, for example, in the purchase of specialist health care, where the consumer is likely to be relatively poorly informed on the treatment necessary as compared with the health professional. The result may be that under private health care the consumer over-consumes medical treatment and medical costs become excessive.
- The market is a natural monopoly so that competition cannot flourish. A natural monopoly occurs where there are appreciable economies of scale or scope, such as in the network industries, where the duplication of gas and water pipelines, electricity transmission and distribution grids and fixed line telecommunication systems would be uneconomic (Sharkey, 1982). In developing countries natural monopoly may be pervasive because the market is insufficiently large to sustain a number of competing organisations operating at an efficient scale.
- There are pervasive externalities in the form of costs (or benefits) to agents who are not involved in the immediate transaction, such as when market production leads to significant pollution. Environmental impacts are a good example of externalities but externalities can exist wherever there is jointness in consumption.

Where there is market failure it is possible to demonstrate that state intervention, provided that it is optimally timed and executed, can lead to higher economic welfare than the unregulated private market. This conclusion is relevant when appraising the likely consequences of any privatisation measure. The benefits of privatisation are predicated on the existence of a competitive,

well-functioning market process. But where this is absent, privatisation can lead to monopoly not competition. For instance, a study of privatisation in Brazil concluded that the result was the conversion of 'public monopolies into private monopolies with no beneficial impact' (Ayres, 1995; also see Saha and Parker, 2002). To make matters worse, the necessary regulatory reforms to address market failure had not been introduced to protect consumers from monopoly abuse.

Moreover, in the specific context of developing economies there may be additional market failures to those listed so far. These are related to the failure of private markets to produce the level and pattern of economic growth necessary to reduce poverty levels in lower-income economies. A Pareto optimal outcome is linked to one particular distribution of income. In developing economies there is usually a large gap between rich and poor, with many living in chronic poverty. A primary goal of state regulation, therefore, may be to ensure that markets contribute to poverty reduction. Markets can have both direct and indirect effects on poverty reduction: direct impacts may result from improving access for poor people to markets, as buyers or sellers; indirect impacts may occur through the 'trickle-down' effects of the overall rate and pattern of economic growth. But it is not self-evident that private markets will reduce poverty, indeed they may exacerbate it. Even where economic growth raises all incomes over time as private markets expand, the time period involved may be very lengthy indeed, and the distribution of the benefits may be very uneven. An important goal of state regulation of markets, therefore, may be poverty reduction. In this case, regulation is concerned with promoting economic development and raising income levels across the population and particularly among the poor, implying that the efficient private markets alone are unable to achieve this socially desirable outcome.

At the same time, however, state regulation may flourish for a set of altogether different reasons unrelated to market failure or development needs. This set of reasons for the regulatory state is associated not with the promotion of the public good but with private advantage. Because the state is powerful and probably omnipotent, it becomes a source of patronage and economic advantage. Political lobbying, including what in US political circles is known as 'pork barrel politics' under which politicians dispense political favours, leads to a very different perspective on the origins and nature of state regulation to that associated with market failure arguments. In this approach, regulation is either created at the outset to favour special interest groups or, even if its origins lie in a true concern with market failure, it is over time 'captured' by special interests intent on promoting their own economic rents (Stigler, 1971; Posner, 1974; Peltzman, 1976). In the regulatory state, governments wield considerable discretionary power to determine outputs and inputs and therefore income and wealth distribution. Not surprisingly, therefore, they

become subject to continuous lobbying by interest groups to ensure that the regulatory outcomes are favourable to them.

Farming interests are a particularly good example of this in the EU, North America and Japan. Through lobbying, including street demonstrations and the occasional blockading of transport routes, they are able to win government financial support and restrict the import of cheap food from other parts of the world. The result is a higher income for domestic farmers but at a big economic cost in the form of higher prices to domestic consumers and lower incomes for farmers in other parts of the world. Such lobbying activities extend, however, well beyond agriculture to all areas of the economy where governments through their regulatory powers can successfully redistribute incomes. Lobbying groups are more likely to be monitored to reduce rather than increase competition. State regulation will then be associated with restricting market entry rather than the promotion of competition, even though the latter would lead to greater economic good (Djankov et al., 2002). The result is then a degree of 'state failure' that could even exceed the market failure that regulation is intended to address.

It can be simply demonstrated that provided the cost to an individual of participating in lobbying does not exceed the benefits that the individual anticipates from taking part in the lobbying, then lobbying of government will take place. Thus, for example, an industry threatened by closure in the absence of state subsidies or trade protection will quickly gather considerable support from its stakeholders. These stakeholders will include the workers, their trade unions, employer organisations, investors, suppliers and members of parliament in directly affected constituencies. Together they create a formidable lobbying force for protection from market forces. By contrast, taxpayers and consumers, although at risk of considerable welfare loss as a group from having to finance state subsidies or through having to pay higher prices, are unlikely to find it individually efficient to take part in lobbying activity. For this reason, state regulation tends to have an underlying momentum to expand continuously. Or, more correctly, to expand to such a point that the costs of regulation begin so obviously to outweigh any possible benefits that a public reaction takes place. Over time the consequence may be cycles of regulation and deregulation.

Allied to this tendency towards 'regulatory capture' is the notion of 'political capture'. Political capture involves the regulatory machinery being used primarily to further the political interests of members of the government, and the argument is related to a wider critique of government contained in 'public choice theory' or 'the economics of politics' literature (e.g. Niskanen, 1971; Tullock, 1976; Mitchell, 1988; Tullock et al., 2000). Under conditions of political capture regulation is shaped to further the interests of the political elite. For example, regulatory bodies may be staffed by members of this elite and

regulatory measures may be shaped to enhance their economic welfare. The possibility of such capture is furthered by a lack of informed opinion outside government and the absence of an independent media and judiciary. In these conditions, which describe reality in many lower-income economies, capture may extend to cronyism in regulatory decision making and even outright corruption of officials (e.g. Theobald, 1990; Craig, 2000; Duckett, 2001; Tangri and Mwenda, 2001). Political capture is a form of regulatory capture under which regulation is designed and promoted to meet the needs of the political elite and to preserve its power. The regulatory state is then self-serving.

The market failure rationale for regulation contrasts dramatically, of course, with notions of regulation resulting from regulatory and political capture. In conditions of capture, state regulation is unlikely to gain widespread public sympathy or 'legitimacy'. Regulatory legitimacy exists when the regulatory institutions, while still subject to criticism because of particular decisions or behaviour, are generally accepted within society. Achieving this public acceptance occurs over time and as public confidence in the regulators is built. To achieve legitimacy, regulation is commonly linked to the following attributes of 'good' regulation (Haskins, 2000, p. 60), namely:

- transparency
- accountability
- targeting
- proportionality
- consistency.

Transparency refers to the regulatory process being open to public scrutiny. A transparent regulatory regime allows the public to appreciate the grounds for regulatory decisions and facilitates public consultation and challenge. An accountable regulatory regime is one in which regulation is answerable to the public or more usually to the public's representatives in parliament. A targeted regulatory system is one in which the regulations introduced to correct market failure are not so loosely drafted that they impact unintentionally on other parts of the economy. Proportionality is concerned with regulation introduced being proportional to the problem or market failure identified. The sledge hammer should not be used to crack the nut! Finally, consistency is a further important attribute of 'good' regulation. Consistency in regulatory decisions means that the regulator's actions become more predictable, leading to less disruption to the economy. Inconsistent regulation creates great uncertainty in the private sector and may well have a seriously damaging effect on investment.

In addition to this set of criteria for legitimacy, other important issues in the study of regulation relate to regulatory costs and regulatory risk.

Regulatory costs or the costs of regulation to an economy can be divided into the direct costs of administering the regulations, which will be reflected in the budgets of the regulatory departments, and the costs imposed on the remainder of the economy in terms of complying with the regulations. The latter are a form of 'compliance cost' (Parker, 2002). In principle, the administrative and compliance costs of regulation should be compared to the benefits accruing from the regulation, thereby promoting efficiency in the administration of regulation. However, it may be difficult to estimate the benefits, in which case the objective should be to minimise the costs of regulation to achieve a given (assumed) regulatory benefit. While governments can measure directly the administrative costs, compliance costs are usually hidden from view. But they can be appreciable; for instance in the USA they are said to be as much as $700 bn. This contrasts with a figure for direct regulatory costs borne by federal agencies of some $25 bn (Hopkins, 1996, cited in Blundell and Robinson, 2000).

In addition to the administration and compliance costs of regulation, the effects of regulation on the economy are related to the degree of 'regulatory risk' created. Whereas competitive, unregulated markets are associated with the normal commercial risks of trading, relating to changes in demand and supply and developments in the macro-economy such as interest rate changes, regulated markets suffer from an additional risk. Regulatory risk is an outcome of uncertainty and inconsistency in the regulatory regime, which leaves private agents including businesses fearful of current and future regulatory decisions. Where regulatory risk is appreciable, investors will seek compensation in the form of a larger expected return, so leading to a higher cost of capital. The higher the cost of capital, the lower will be the rate of investment (Guasch and Hahn, 1999; Hahn, 1998). Where regulatory risk becomes very high, private investment may even collapse. Lower-income economies with poorly developed institutional structures, including regulatory agencies, are likely to be associated with high regulatory risk (Levy and Spiller, 1996). This is an important reason for the study of regulation in the context of economic development, with the aim of improving regulatory decision making and processes in the developing world.

Regulatory impact assessment (RIA) is a term used to describe the process of systematically assessing the benefits and costs of a new regulation or an existing regulation, with the aim of improving the quality of regulatory policy. By assessing the positive and negative impacts of potential and existing regulatory measures, RIA can be used as a tool in the design and implementation of regulatory measures. By adopting the principles of transparency and accountability, RIA can also help in establishing the legitimacy of state regulation (Kirkpatrick and Parker, 2003).

Another set of issues in the study of regulation relates to the regulatory

structures and regulatory instruments used. Regulatory structure is concerned with the form of administration that the regulation takes. Regulation may, for example, be conducted by government departments or it may be delegated to dedicated regulatory agencies, such as the Office of Telecommunications in the UK and the Federal Communications Commission in the USA. Such arm's length or 'independent' regulation – independent in the sense of being free from day-to-day political intervention though not of course free from public accountability – helps to reduce regulatory risk. The result should be 'better' regulation in terms of the above attributes of 'good' regulation and in particular consistent regulation. The result should be a lower cost of capital and therefore more investment in the regulated industries. This and related matters are pursued further in the discussion of regulatory governance in the next section of this chapter.

Regulatory instruments are the tools and techniques that the regulator uses in the pursuit of effective regulation. In particular, utility regulators will be concerned with the setting of prices and/or profits in the regulated business and with the quality of service. Although various differences exist in the precise instruments used, the approach to price and profit regulation tends to take one of three general forms; namely, cost of service regulation, price cap regulation or sliding scale regulation.

- Cost of service regulation involves the regulator agreeing the level of operating costs (wages, fuel costs, etc.) and the capital costs (interest on debt financing and depreciation charges on the capital stock) for the regulatory period. To this is added a profit or agreed rate of return based on the firm's cost of capital. The product is the level of revenue needed to achieve the agreed rate of return given the anticipated costs of production. Once the volume of output is forecast then the necessary prices that need to be set are determined. This approach to regulation is sometimes referred to as 'rate of return regulation' and has been used widely in the USA and elsewhere for many years. Usually, if profits turn out to be higher than agreed, perhaps because costs turn out to be lower than forecast or the volume of sales expands more quickly than expected, then the firm is expected to cut its prices to restore the agreed level of profit. While seemingly simple in structure, cost of service regulation is associated with disincentives to reduce operating and capital costs because these can be passed through to consumers in higher prices, and incentives to over-invest, thereby expanding the asset base on which the allowed rate of return is calculated (Averch and Johnson, 1962; Kahn, 1995, pp. 49–59).
- A price cap is an alternative approach to regulating revenues in which profits are not determined by the regulator but are a residual. Under a

price cap the regulator agrees the forecast operating and capital costs with the regulated firm, as under cost of service regulation, but then applies an efficiency gain factor, 'X'. This X efficiency factor is normally based on some estimate of productivity growth in the industry compared with the economy in general. This estimate may result from benchmarking the firm's performance (or 'yardstick' comparisons) with other firms' efficiency growth across the industry or with similar industries or internationally. Whereas average productivity growth across the economy is reflected in price inflation or the Consumer Price Index (CPI), higher or lower than expected productivity growth in the regulated sector is reflected in the X factor price adjustment. The formula for the price cap is then, CPI+/–X. The result is an incentive for the firm to outperform in terms of reducing costs or attracting customers, leading to higher profits (Littlechild, 1983; Viehoff, 1995). The UK has championed price cap regulation because of its supposed incentive effects and price caps have now been adopted in many countries, including in some developing economies, to regulate their privatised telecommunications and electricity sectors.

- Sliding scale regulation involves some combination of the price cap and cost of service regime. Typically, with a sliding scale a price cap operates up to a given level of reported profit, but once the profit exceeds this level then prices are reduced to consumers pro rata to the level of the excess profit, thus sharing the efficiency gains more quickly between consumers and producers than with a pure price cap (Burns et al., 1995). This approach to regulation ensures that profits cannot be excessive for long periods and helps reduce political and social opposition to the regulatory regime that can exist when profits rise sharply, especially in what are perceived to be essential public services such as water and power (Parker, 1998). At the same time, however, when profits are clawed back the incentive for management to reduce costs is reduced. If profits are clawed back immediately, the regime can degenerate into a form of cost of service regulation.

These explanations of the three different approaches to price and profit regulation are by their nature very general and details do differ across the countries which use them. Also, and importantly, all these three methods of price and profit regulation are demanding in terms of information needs. With cost of service regulation, price caps and sliding scales the regulator must overcome the same information asymmetries so that costs, revenues, consumer demand, the asset base, and the true cost of capital can be computed reasonably accurately (Armstrong et al., 1994; Alexander and Irwin, 1996; Vass, 1997; Grout, 1997). In practice, this has proved to be no easy task even for regulators in OECD countries (Souter, 1994). The result can be lengthy

appeals against regulators' decisions. For example, in the USA regulation is often appealed to the courts, leading to acrimonious arguments between the regulator and the regulated. Similarly, the UK mode of regulation based on price caps has produced animosity between industries and their regulatory offices, alongside consumer complaints about high profits and 'fat cat' management salaries (Parker, 1998, 1999).

Moreover, in developing countries these three different approaches to regulation are each likely to face difficulties because of a lack of regulatory capacity. Although the UK has exported price cap regulation in preference to the alternatives, it is not self-evident that all or even many developing countries have the regulatory capacity to operate a price cap effectively for long periods. Even in the UK the regime faces strains (Parker, 1998). Regulatory capacity is concerned with the resources available to government to regulate effectively. In developing countries regulatory offices are likely to have limited access to skilled regulatory staff. They may be unable to pay salary levels to attract skilled personnel because of depressed civil service pay scales, and may be subject to day-to-day political intervention even when the regulators are nominally independent. In the face of political capture, the regulatory process may lack legitimacy, so leading to deep suspicions on the part of investors as to the process and outcomes of the regulatory regime, especially if the head of the regulatory office is clearly a political appointment. All regulatory systems are prone to 'gaming' where the parties attempt to capitalise on information asymmetries to maximise their own rents (Bradbury and Ross, 1991; Veljanovski, 1991). But in developing countries, lacking a tradition of probity in government and perhaps an independent media and judiciary, and where the information asymmetries between the regulated and the regulator may be huge, such gaming can be expected to flourish.

This discussion suggests the following are important areas for research into regulation in developing countries:

- The nature of information asymmetries in the specific context of developing economies and how they might be best addressed.
- The role of incentives within different regulatory regimes and the lessons to be learned.
- The rationale for regulatory practice and the comparative roles of market failure and regulatory and political capture.
- The extent to which the attributes of 'good' regulation can be realistically achieved in a developing country context and the implications for regulatory reform.
- The optimal regulatory structures to adopt and particularly the relevance of 'independent' regulation and 'regulatory gaming' where there is a lack of regulatory capacity.

- The relative merits of cost of service regulation, price caps and sliding scales in economies very different to the developed countries where these methods primarily originated.
- The need for regulatory capacity building and the precise forms this should take.

REGULATORY GOVERNANCE

It is clear from the discussion thus far that the analysis of regulation (and indeed of competition policies and instruments) cannot be limited to the economic issues that until recently have been foremost in the literature on regulation in developed economies. Not only are ideological issues involved; that is, competing ideas on the best or most appropriate relationship of state and market, it is also the case that since it is governments that must take the initiative in designing and promoting these and related economic reforms, they become the subject of normal policy, political and bureaucratic processes. Both intentions and outcomes are therefore determined by a combination of economic, social, political and bureaucratic factors, and cannot be attributed to one set of factors alone. It is the acceptance that there is this broader framework to issues of competition and regulation that has produced the relatively recent focus on 'regulatory governance' in the literature relating to developed economies (for a survey of this literature see Minogue, 2001b, 2002b). This broader focus, and the involvement of other disciplines than economics (law and political science in particular) has also brought a degree of fuzziness in definitions of regulation. A simple broad definition is 'the use of public authority to set and apply rules and standards' (Hood et al., 1999). A distinction may then be made between the *regulation of business* (the controls exerted over private, non-state activities) and *regulation inside government* (the controls exerted within and between government agencies, and between levels of national government.) We might also add *international regulation* (regulation of national governments by supranational mechanisms); *self-regulation*, constituted by less formal alternatives than legislative or administrative rulemaking; and *metaregulation*, which implies an overarching system for reviewing regulatory mechanisms within government policy-making processes. Finally, the notion of *deregulation* falls within the field of analysis because of the essential relationship to regulation, while *competition* provides a significant framework of objectives for regulatory systems

When we turn to 'governance' we also find a lack of definitional clarity in the literature. Rhodes declares that 'governance has too many meanings to be useful, but the concept can be rescued by stipulating one meaning and

showing how it contributes to the analysis of change' (Rhodes, 1997, pp. 52–3). The 'governance of regulation and competition' might be taken to cover:

- the whole range of government institutions involved in rule-making and implementation;
- the public policy processes which involve this set of institutions;
- the interactions of public organisations and actors with private organisations and actors;
- the significance of political factors: political will and leadership; the interactions of political and economic elites; political interventions in rule adjudication (especially in the actions of judicial or other regulatory actors); and the use of political relationships either to achieve regulatory capture *or* to build trust relationships which underpin effective informal regulation;
- the system of public values which provides the setting for regulation and competition.

A particular concern must be to establish which types of regulation are most effective in delivering benefits to ordinary citizens (and disadvantaged groups of citizens such as the poor) through improved and less costly services, whether provided by the public sector, the private sector, or jointly.

Another broad framework with some relevance is that provided by human rights issues. The practice of human rights necessarily operates within formal legal systems, but there is a more immediate realisation through mechanisms of economic regulation such as employment law and practice (child labour, equal opportunities). In the varied social and political cultures of developing economies the precise formulation of human rights gives rise to disputes about what regulatory claims can or should be made.

Literature reviews and initial 'mapping' surveys by the Centre on Regulation and Competition (CRC) at the University of Manchester and its network of research partners in both developed and developing economies have produced a number of tentative findings. In relation to *institutional structures and relationships*, these findings are:

- there are serious gaps in our knowledge and understanding of the regulatory process in developing economies;
- regulatory structures in developing countries appear to serve a range of objectives other than efficiency;
- due attention to governance and public policy processes (i.e. how things really work in practice) is essential to effective regulatory reform;
- direct regulation by the state machinery of government continues to be

widespread, so it is important to consider 'regulation inside government' as a likely province for regulatory reforms;
- nonetheless, there are certain obvious candidates for deregulation where bureaucratic controls (such as licensing) exert significant constraints on economic performance without conferring any discernible public interest benefit;
- transferred 'best practice' models demonstrate clear adaptive variations in different countries, and it is likely that the 'blind' importing of these models from developed economies will be counterproductive where no account is taken of differences in legal infrastructure, bureaucratic culture, market realities, and political values;
- self-regulation appears to be relatively unexplored as an alternative type of regulatory mechanism;
- regulatory agencies have done little to establish what are their own internal capacity-building needs; knowledge of dominant regulatory reform models is sketchy, and these are prone to local misinterpretation;
- a key task is to design regulatory structures so that opportunities for corruption are minimised.

In relation to *regulation, politics and poverty* the key findings are:

- political institutions and relationships constitute a primary operating context for economic reforms;
- but these political factors are frequently neglected or inadequately understood by external economic policy actors;
- regulatory agencies are as likely to be 'captured' at the policy design stage as at the implementation stage;
- well-organised and institutionally entrenched political interests will often succeed in controlling or subverting economic agencies;
- but authoritative and stable political interests can be a driver for economic reforms;
- market reforms of basic public services are likely to meet political and user resistance if they reduce access, affordability and quality;
- the impact of such reforms on the poor is under-researched and poorly understood.

THE POLITICS OF REGULATION AND COMPETITION

Earlier in this chapter a distinction was drawn between 'regulatory capture', largely construed to cover information asymmetries between regulatory agencies and regulated bodies, and 'political capture'. Politics might be treated in

two senses here, both as ideology and as practice. At the level of ideas, different political philosophies involve different views about the appropriate relationship between the state and the market, and between the state and society. The debate between the more extreme paradigms of state–economy–society relations may well be dead, but the ship of state remains stubbornly afloat, if now pointing in a different direction. One commentator suggests that 'it is generally more appropriate to speak of shifting roles of government than of shrinking roles of government' (Kooiman, 1999).

This is doubtless because practical politics ensures that conflicting views over public–private boundaries are mediated through a process characterised by negotiation; that radical policies will be constrained by electoral cycles, or other mechanisms of appointment and replacement; and that substantial changes in rules (and especially in the structure of rule-making) operate over long rather than short time scales. Whether we call the process regulatory capture or political capture, what is at issue is effective control or domination of regulatory mechanisms by the interests who are the object of regulation. Both regulatory design and implementation may be seriously weakened by regulatory capture, and also by internal resistance where regulation inside government is involved. Political factors can be significant in their effects on regulation between levels of government; for example, where different political authorities control central and sub-central governments

A significant practical issue comes under the heading of 'policy transfer'. Since aid donors are likely to bring pressure to bear on developing country aid recipients to introduce competition and regulatory systems and methods which characterise the economic policy systems of developed economies, issues of appropriateness and adaptability arise. The problems of direct policy transfer across cultural boundaries are beginning to be well documented, but are still under-researched in relation to the wave of public management reforms of the past two decades. The literature on policy transfer as it relates to more general market-oriented governance reforms in developing economies is still fairly sparse, but what there is tends to the conclusion that reforms are largely rhetorical; blueprints are borrowed, but honoured in the breach more than the observance, with considerable local variation in reform trajectories, where such can be said to exist (Common, 1998, 1999; Parker, 2003). The blueprint itself has been subjected to critiques for being too 'top-down' (Wallis and Dollery, 2001) and for being inappropriate to the bureaucratic/managerial cultures characteristic in developing countries (Minogue, 2002a; Schick, 1998). Even in developed economies, the 'new public management' model has not been properly evaluated (Pollitt and Bouckaert, 2000), and, for example in the UK, has been substantially attacked for bringing more damage than benefit to the efficient provision of public services (Minogue, 2001a). The reforms associated with 'regulatory governance', privatisation and post-privatisation regulation are

closely related in conceptual terms, but also in practice, to the general process of public management reform. The ways in which these reform ideas have been transferred and adapted to developing country economic and political systems needs to be examined in detail.

REGULATORY GOVERNANCE: THE RESEARCH AGENDA

Generally, regulatory systems both internal and external to government are weak in developing countries. The reasons for this weakness need to be established, and are hypothesised to lie partly in low levels of government legitimacy, partly in institutional underdevelopment, and partly in 'political capture'. While we are familiar with the existence of regulatory and political capture, we still do not have much research evidence on how this process operates in developing countries, where the political character of regulatory capture is more pronounced than in developed economies; and also where regulatory capture is often internalised within government itself. A related issue is the constraints on efficient and effective policy and administration that flow from the cultural characteristics of the government system; a good example here is the persistence and pervasiveness of corrupt behaviour (Minogue, 2002a). We need to understand better how these political and bureaucratic factors impede effective regulatory design and implementation. We also need a better understanding of the role and operation of legal institutions and actors in regulatory systems which are politically and behaviourally constrained. There is therefore a link between general public management reform and regulatory reform, in the sense that the effectiveness of any area of public policy, including regulation and competition policy, will be determined by whatever are the bureaucratic and political constraints and weaknesses inherent in the general system of governance. Political factors may be taken in principle to represent an opportunity for commitment to effective regulation (Moran, 2002; Braithwaite, 1999; Hood, 1998) but are more likely to be a potential source of inhibition.

This approach is strengthened by the recognition that, as noted earlier, regulatory governance embraces what has come to be called 'regulation inside government' (Hood et al., 1999). Regulation is frequently treated as something that is by definition external to and independent of government, but in principle government has always been heavily involved in regulation (hence the use of the term 'deregulation' to indicate the removal of government rules, restrictions, or even provision). In developed economies, despite the tendency of neoliberal reforms to take whole areas of economic activity outside government through privatisation, or to reduce government controls through deregulation, significant regulatory responsibilities remain with the state, and in some

respects have been changed into new requirements for audit and oversight to fill the public interest accountability gaps left by privatisation and deregulation. In developing economies, where privatisation has pursued a rather erratic and patchy course, substantial regulatory responsibilities remain with both central and local public authorities. The tension between efficiency objectives and political imperatives is clearly marked, and is itself responsible for the relatively slow progress of institutional reforms. Public management reform may have a significant influence on economic reforms if the overriding need is to improve the quality of regulation inside government rather than to take regulation outside government.

A related area for investigation might be the interface between the public and private sectors created by new managerial initiatives through contracting and public–private partnerships. These initiatives have created new hybrid forms of action which are neither wholly public sector nor wholly private sector. They involve an attempt to separate public funding and accountability from operational delivery of services to the public; in some cases they also represent an attempt to draw in market investment to supplement scarce public resources; yet other variations draw in community resources to supplement both state and private provision. Research would seek to establish the regulatory patterns required by these new forms of public action in developed countries, and their applicability to developing economies.

Another related research possibility could focus on the concept of trust as an alternative to regulation. A main critique of contracting is that because it necessarily operates in a framework of directive formal rules, the relations of collaboration that underpin direct government provision are missing or damaged. An alternative approach is to concentrate on building relations of trust between public and private partners within a less formalised regulatory framework, as advocated for developed economies (Ayres and Braithwaite, 1992). The relative appropriateness of these alternatives (formalistic, or trust-based) for developing country regulatory systems needs to be explored.

A broader but related area for research is the possibility of 'regulation by values', focusing on regulatory mechanisms for the protection of economic and social rights, and on the creation of a public service ethics within governments. Both aspects deserve more attention in the light of the identifiably adverse consequences of economic liberalisation. Research of this kind would also draw in developing arrangements for the improvement of business ethics.

AN OUTLINE OF THE BOOK CONTENTS

The book consists of 21 chapters including this introduction. The chapters have been organised into three sections, with Part 1 providing an introductory

overview. The chapters in Part 2 focus on *leading concepts and issues in competition, regulation and development*.

Chapter 2 by Paul Cook deals with the promotion of competition in developing countries. Despite differences, developing countries are generally characterised by lower degrees of market competition than their industrialised country counterparts. Until relatively recently, few developing countries had OECD-type competition policies. Cook demonstrates that the heightened interest in competition in developing countries has various explanations. He argues that in part it is undoubtedly linked to the wave of neoliberal economic reforms introduced since the 1980s, including privatisation. This view sees government control, and in particular regulation, as the main vehicle for enriching politicians and promoting corruption and, therefore, as a fundamental problem. As a consequence, deregulation and liberalisation are seen as inevitable solutions. Also, he contends that the increased emphasis on competition is linked to concerns in developing countries over weak systems of corporate governance, leading to greater enterprise inefficiency. Competition is often viewed as a substitute for corporate governance. But he also points out that the new interest in competition in developing countries has exposed how little is known of the effectiveness of competition policies and about the ways in which competitive processes work in developing countries. The purpose of the chapter is to select and examine a few critical areas that need to be considered when developing and evaluating competition policy in these countries. Different approaches to competition policy can then be characterised according to the relative emphasis that each places on the incentives for the acquisition of assets versus incentives for their use. The chapter draws on theory to consider issues relating to factors that inhibit competition and to discuss their implications for policy in developing countries.

Chapter 3 by J.S. Metcalfe, R. Ramlogan and E. Uyarra reviews some recent thinking on the connection between competition and development as a prelude to a study of wider concerns about innovation, income distribution, competition and development policy. The position taken by the authors is that the problems of competitiveness and economic development are isomorphic by virtue of being examples of the phenomenon of economic evolution. Economic evolution is a theory of how the world changes, or rather how it changes in such an uneven fashion. The authors review ideas on the history of the concept of competition and go on to develop an evolutionary approach to competition and competitive advantage, in particular examining issues relating to innovation and development. They conclude that competition is central to the development process, but that competition is a process not a state of affairs. Consequently competition policy is not reducible to a simple-minded concern with the exploitation of market power, rather in its fundamentals it is a matter of the creativity of an economic system.

Chapter 4 by David Parker and Colin Kirkpatrick identifies the main issues that need to be considered when examining economic regulation in developing countries. To provide a basis for this examination, Parker and Kirkpatrick draw on a range of theoretical propositions derived from the literature on the economics of regulation. Parker and Kirkpatrick examine six wide-ranging propositions that have implications for the success or failure of regulation. Principally these relate to the degree to which regulation is embedded in institutional arrangements; the extent of information asymmetries; the nature of regulatory contracts; the extent to which regulatory systems are prone to various types of capture; the trade-offs between effective and efficient regulation; and finally, the place for competition. Parker and Kirkpatrick then consider these propositions in relation to the needs of developing countries in order to establish a methodology for understanding how regulation works in these countries. They argue that both the theory and the experience of regulation in developed countries does have relevance for developing countries but the theory and its application cannot be naively transferred to them.

In Chapter 5, Peter Holmes discusses the issue of trade and competition policy that was put on the agenda of the WTO in 1996. In the chapter Holmes asks what justification there is for a multilateral agreement relating to competition and, critically, what it should include. He examines the legal position with respect to trade and law on competition policy and finds that current rules provide an unclear picture that could result in costly litigation to get clarification on what the rules mean. The final part of the chapter reviews the proposals for reform from a European Union perspective.

Graeme Hodge studies some critical issues in private sector development strategy in Chapter 6. The aim of this chapter is to reflect on the concept of a private sector development strategy (PSD strategy) and to articulate aspects of the PSD strategies of the Asian Development Bank and the World Bank, in order to identify both commonalities and differences. These strategies are reviewed as devices for corporate direction-setting and policy-making in the context of the privatisation of state-owned enterprises, economic regulation and competition. In particular, he considers issues arising when strategy is viewed as an evolutionary and learning phenomenon in organisations. The study argues that PSD strategy is essentially not strategy at all in the usual sense of corporate direction-setting and policy implementation, but is a mixture of affirmations, actions, goals, aspirations and belief. The consequence of this is that there are large gaps between the image of corporate direction-setting in development banks through definite initiatives for change and the actuality of generalised policy statements at senior levels, and both uncertainty and rhetorical conflict at officer level. The chapter also argues that, as a consequence, many of the traditional arguments, philosophical battles and failures to learn from empirical experience that have characterised decades of

debate on privatisation, regulation and competition policy for development now continue beneath the surface of the PSD strategy paradigm. The chapter questions whether the development banks are capable of meeting the need for new models of regulation and competition. Meeting this challenge will require the banks themselves to redevelop PSD strategies that are more culturally relevant, to increase their internal capacity to learn from the breadth of experience to date and also to be more explicit about the inevitability of power sharing as part of successful reform. Thus far, the pattern seems to have been one of simply asserting private over public, markets over governments, and quick actions over more gradual, difficult but informed and effective reforms in privatisation, regulation and competition.

Chapter 7 by Anthony Ogus aims to identify and compare the key features of regulatory systems in industrialised countries. By way of essential background, the first section deals with the constitutional and cultural environment that underpins the systems, but it also includes a discussion of regulatory traditions and styles which, for example as between anglophone and continental European regimes, are significantly different. Institutional frameworks are discussed in the second section, covering, *inter alia*, the relationship between regulatory agencies and government, the breadth of remit of regulatory institutions and the degree of discretion conferred on them by legislation. The latter necessarily gives rise to issues concerning the forms and institutions of accountability. The chapter then considers regulatory procedures and management. Noteworthy here are, on the one hand, the systems of consultation and the extent to which public hearings are encouraged and, on the other, cost–benefit or regulatory impact analysis which, in some jurisdictions, is mandatory for regulatory policy-makers. The final section is concerned with legal instruments and concentrates on the growing distance between traditional 'command and control' methods and those relying on financial incentives and other economic instruments. A brief conclusion emphasises the pitfalls that attend an extension of the comparison to the different institutional contexts of developing countries.

The focus of Martin Minogue's chapter, Chapter 8, is on the conceptual and empirical problems that arise in the analysis of the administrative and political context of economic and social regulation in developing countries. After a discussion of the significance of dominant ideas in current debates on economic and social development policy, the chapter examines the main characteristics of regulatory governance in developed economies, since the privatisation and regulatory reforms recently introduced into developing economies are broadly modelled on developed country experience. It is argued that regulatory reforms need to be analysed in the broader context of the new public management (NPM) and governance reforms, which have been spreading across both developed and developing systems of government in the last two

decades. One reason for close attention to systems of governance is that in developing countries, the state is likely to retain greater responsibilities for economic and social regulation than is now the case in developed economies. In this event, 'western' models of regulation will not be easily emulated or transferred because of the resistant political and administrative cultures that must receive them. The forms of this 'reality gap' are examined, and the implications for the reshaping of state–market relations in developing countries are considered, as well as the implications for pro-poor strategies.

A principal practical concern for regulatory agencies is to acquire and develop the internal institutional skills needed to secure effective regulatory performance. In Chapter 9, Derek Eldridge explores the utility of a specific diagnostic methodology linked to capacity-building issues and performance management. The chapter reviews the advantages and constraints associated with the application of this approach to regulatory organisations.

Chapter 10 by Richard Heeks and Richard Duncombe looks at how ethical trade – initiatives that seek to improve the social and environmental impacts of global supply chains – is growing because of perceived shortcomings in globalisation and in traditional forms of state regulation. This chapter analyses and categorises stakeholders, incentives and mechanisms of ethical trade. On the basis of current (limited) evidence, it summarises the impact of ethical trade via six performance measures: existence, extent, expedience, effectiveness, efficiency, and externalities. The mixed picture of impacts is analysed and understood from two perspectives: a design focus, and an institutional focus. The former sees impacts as guided by design–reality gaps in the planning and implementation of initiatives. The latter identifies key institutional elements affecting impacts: underlying stakeholder interests, regulatory incentives, asymmetries of power and information, and trust. The chapter concludes by looking at regulatory changes and challenges arising from globalisation; by critiquing current recommendations for ethical trade improvement; and by identifying ongoing research issues.

The chapters in Part 3 provide *case studies of policies and practice in developing countries.* Chapter 11 by Cassey Lee reviews the regulatory reforms that have been introduced as a consequence of privatisation in Malaysia since the mid-1980s. The author describes the sectoral approach to economic regulation that has been adopted in sectors where privatisation has taken place, and points out the limited attention given to competition regulation. Only the communications and multimedia sector has provisions for this. The author discusses the government's plans to introduce a national competition policy and analyses how the objectives of competition policy might conflict with other regulatory goals aimed at poverty eradication and wealth redistribution.

In Chapter 12, Kobus Müller examines the institutional and policy framework for competition and regulation in South Africa. Both the public and

private sectors in South Africa are committed to changing the current situation of inequity, inequality and poverty. Competition and competitiveness are regarded as useful instruments to stimulate economic growth. South Africa has positioned itself as a country leaning towards the public interest model of government, and has adopted legislation providing for competition. International agreements in terms of competition have also been signed.

Major restructuring has taken place as regards institutional structures and regulatory responsibilities. Enterprises have been privatised, but are regulated by separate, state-funded bodies with judicial powers and accountability to taxpayers. There is potential conflict between regulatory and competition authorities about their roles.

Policies for social and economic regulation, designed to empower the disadvantaged, seem unable to promote growth and investment. According to the South African approach to privatisation the state remains the major stakeholder in partnerships. Self-regulation has increased, while regulatory measures have already had an impact on income statistics beyond ethnic lines.

The tripartite government alliance in the country is not in agreement on the regulation of the economy. Government, organised business and labour together with organised society formed the National Economic Development and Labour Council (Nedlac) to address issues of social and economic policy.

This chapter identifies gaps in the institutional and policy framework, which include representational, judicial, accountability, coordination, globalisation and ethical issues. The challenge is to find a balance between conflicting economic and social objectives, to enhance competition, reduce state debt and widen ownership in the economy.

In Chapter 13 Ledivina Cariño maps out the terrain of regulatory governance in the Philippines, describing the constitutional and legal frameworks of regulation and the economy. The examination of the institutional framework describes the role of the three branches of government, then the various means of organising the regulatory agencies, focusing primarily on how they tackle the joint pressures of involvement and independence. Emerging regulatory mechanisms in the private sector and civil society are also presented. This chapter argues that the contrasting pull of nationalism on the one hand, and globalisation and liberalisation on the other are the most significant forces shaping regulatory governance today.

The policy shift in the developing world over the last two decades, towards market mechanisms as instruments of economic growth and poverty reduction, has been paralleled by the emergence of a new role for the state from provider to facilitator/regulator. As Malathy Knight-John emphasises in Chapter 14, Sri Lanka has not been an exception in this regard. Although Sri Lanka moved from an import substituting and heavily state interventionist economy to a more liberalised one in 1977, competition legislation and legislation for regulating

telecommunications, passenger bus transport, and the financial sector were only introduced later. Civil strife, pressures to finance the state's burgeoning fiscal deficit and the related move to opt for rapid privatisation contributed to placing competition and regulatory concerns on the backburner. Moreover, while the formal institutional and legal structures for competition and regulation now exist, distortionary intervention and bureaucratic micromanagement by the state are not uncommon. The study shows that regulatory practices have tended to stifle rather than enhance or promote competition in Sri Lanka. This raises important policy questions that Knight-John pursues.

Chapter 15 by Ernest Aryeetey discusses the development of the institutional and policy framework for regulation and competition in Ghana over the last ten years in response to the widespread liberalisation of the economy. Its objective is to highlight the different types of institutions and policies being employed to develop a level playing field for economic agents as they interact between themselves and also with consumers. In discussing the history of regulation over a longer period, it shows that while the professed goals have always been to provide equal opportunities for all economic agents, regulation has sometimes been also perceived as a tool for directing the involvement of distinct socioeconomic groups in the economy. The chapter also discusses the legal framework and major institutions for regulation and how they impact on the choice of regulatory approaches.

Chapter 16 by Diana Mitlin explores the impact of regulation and competition policy on the poor. There are a number of anticipated influences both in regard to the poor as consumers and as producers and/or suppliers of goods and services. Potential areas of influence include the impact of regulation and competition policies on the price of basic commodities and services; the quality of commodities and services; opportunities for access to markets for commodities and services; changes in market opportunities for employment and enterprise development (both positive and negative); and changes in externalities such as environmental degradation, and health and safety. Such areas have an evident impact on the well-being of the poor, their capacity to avoid poverty and their development options. The study focuses on a single sector – water services – and considers the impacts for the urban poor. Water was selected because it is a basic need in maintaining life and improving well-being in the short, medium and long term. For the poor, the objective is access to affordable and adequate supplies of water to meet a multitude of needs.

In Chapter 17 Armando Barrientos argues that there is an emerging consensus among multilateral institutions around the need for developing countries to develop and strengthen social protection policies and programmes, as an urgent response to economic crisis and rising vulnerability. The emerging social protection agenda gives regulation a very significant role in reducing social risk and vulnerability and encourages the reform and

extension of existing regulation, and the development of new forms of regulation in developing countries. This includes the extension of labour standards as an important instrument in preventing and mitigating employment. The chapter begins with a characterisation of social protection as an emerging framework for social policy, and a brief discussion of the reasons for its prominence. The second section of the chapter shows, using the specific example of the introduction of individual insurance saving plans in Latin America and transitional economies, that the adoption of social protection has implications for the regulation of enterprises and markets. The third section examines empirically whether social protection regulation is linked to other regulatory domains, and especially the regulation of enterprises and markets. The indicators of labour regulation are shown to be positively correlated with indicators of contract enforcement, firm entry, and credit information regulation – suggesting linkages across regulatory domains.

The discussion in this chapter alerts us to the need to incorporate social protection within the study and evaluation of regulation in developing countries. Regulation constitutes an important component of social protection, especially in the context of the expansion of private and not-for-profit provision of social protection. Social protection regulation is also linked to other regulatory domains, and constitutes an important component of regulatory regimes. Further research is needed to determine these linkages, and to identify regulatory regimes with greater precision.

In Chapter 18, Tan Wooi Syn agrees that the state is central to the design and implementation of privatisation, as it must identify the industry or sector, select candidates, and regulate performance. State support is also necessary where the private sector is unable to bear all the risks in large projects such as infrastructure investment that involves externalities. However, such state intervention can undermine private incentives and reduce efficiency. The success of privatisation then depends on a country's institutional endowments, in particular its regulatory capacity. This chapter considers these issues in the case of Malaysia, where financial difficulties leading to state bailouts and renationalisations highlight the problems of patronage associated with its privatisation programme. Poor design and inappropriate choices of candidates weakened incentives to increase efficiency and investment, so emphasising the importance of institutional criteria in successful privatisation policies.

In Malaysia, political factors shaped privatisation policies and institutions; factional rivalries, centralised decision-making and increased patronage led to weakened institutions and poor service delivery. This case suggests that effective regulation is also likely to be circumscribed by the political context.

Chapter 19 by Raul Fabella and Rafaelita Aldaba examines the regulatory environment of the two most important energy sectors in the Philippines; namely, the power sector and the downstream oil industry sector. The authors

show that significant deregulation in recent years could have profound implications for future industrial structures of these sectors. The chapter goes on to examine the legislation that underpins various reform initiatives and analyses the processes at work to both support and reverse the laws.

In Chapter 20, Thankom Arun provides a guide to the development strategies that have been pursued and to the evolution of regulatory laws and institutions in India. It examines the new legal basis for promoting competition in India, and uses the example of telecommunications to explore some of the economic and political issues relating to regulation of competition in this sector. It shows that regulatory issues need to be addressed in the early stages of reform and that the effectiveness of regulation will be enhanced by reducing the political element in regulatory decision-making.

Finally, in Chapter 21, Claude Chang discusses the development of telecommunications policy in Guyana. Guyana privatised its telecommunications system in 1990 but since the restructuring has been plagued by a series of problems and disputes with weaknesses in government regulation. In spite of some clear service improvements since privatisation, Chang highlights how changes in economic fundamentals and technology militate against maintaining practices and agreements over a long period of time, especially when they become no longer appropriate to the needs of the country. This chapter helps to bring together a number of the competition and regulation issues in earlier chapters through an interesting case study of both successes and failures in government policy. The case study underlines the need for a clear policy on competition and regulation and one which is constantly monitored and updated.

CONCLUSIONS

Developing countries are subject to privatisation, competition and regulatory reforms, often promoted by donor agencies such as the World Bank, IMF, OECD and Asian Development Bank. Recent research has confirmed the importance of sound institutions including regulatory regimes for economic development (North, 1990; Jalilian et al., 2003). This is reflected in the publications of the international agencies, including the World Bank, which have acknowledged the need for effective regulatory institutions if countries are to benefit fully from neoliberal reforms. For example, in 1997 the World Bank commented that ‘although private sector expansion may relieve governments from certain tasks, it also imposes new responsibilities’ (World Bank, 1997). More recently the World Bank has concluded that some developing countries ‘have privatised badly, creating private monopolies still insulated from competition’ and that ‘the challenge of building effective regulatory agencies is enormous and will not automatically lead to better outcomes’ (World Bank, 2003, pp. xv, 103).

This book provides a series of studies of competition, regulation and regulatory governance in an attempt to inter-relate these different aspects of the new regulatory state in the context of developing countries. In this sense the book bridges a gap between the literature on regulation and competition in developed economies and the market liberalisation agenda. The main purpose of the volume is to stimulate debate about the nature and form of competition, regulation and regulatory governance in the development process.

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