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The call for the "regulatory state": Challenges for developing countries

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Bonn, 02 February 2009. After the initial shock the debates about the global financial crisis resulted in a rare agreement between stakeholders whose opinions normally contrast significantly. Politicians, representatives of the business sector and researchers are now vehemently calling for tighter regulation of financial markets. Is this the dawn of a new era where the idea of a "regulatory state" becomes the *leitmotif*? And what do these debates imply for developing countries?

As well as being threatened by inadequate regulation at a global level, most developing countries are also facing the challenge to build national regulatory systems to develop their own economies. Good regulation in areas like antitrust and competition policy, consumer protection and infrastructure is essential for achieving competitiveness and social development. The relevance of good regulations and the difficulties associated with their implementation are particularly evident in the case of infrastructure.

In many countries the lack of access to reliable and efficient infrastructure like electricity, water, sewerage, fixed-line telephony, roads and rails is a key bottleneck to economic and social development. For example, businesses need to purchase expensive diesel generators to provide electricity, and households have to rely on a water source that is often contaminated, thus leading to waterborne related diseases being spread to the population.

Regulating infrastructure services is particularly demanding because they are "natural monopolies". This means that competition is usually not desirable because instead of lowering production costs, competition can result in cost rises. For instance, competition in the market for supplying electricity means that several parallel transmission grids have to be built and operated. This results in a substantially higher cost than supplying electricity from one single transmission grid.

From the perspective of the regulatory state that wants to protect consumers from the abuse of market power and encourage efficient infrastructure services, this poses a dilemma. In order to take advantage of lower production costs, monopolies should be encouraged. However, this comes at the price of creating monopoly firms that are in the position to charge high fees to users and deliver a substandard service, as there is no competition. The two usual answers to this problem have been to install a monopoly regulation that controls the fees and the quality of services that are offered, or to put state corporations in charge of delivering infrastructure services. This latter strategy, though, has not been successful, as underinvestment and inefficient services in developing countries has occurred.

Following the mainstream market-based approach to infrastructure reform of the 1990s, and encouraged by the international financing organisations, many developing countries have reformed their infrastructure sectors, opening them up to private investors, commercialising service providers, and encouraging "competition for the market" (e.g. by franchising the monopoly right to provide infrastructure). Regulation, however, in most countries remains the Achilles' heel that constrains investments as well as efficiency, quality and sustainability of services. This weakness is routed in essentially two things:

Firstly, it has to be acknowledged that infrastructure regulation is a complicated task that requires technical, economic and legal expertise. Building up the necessary human resources and establishing the information flows between stakeholders (regulators, consumers and service providers), as well as providing regulatory authorities with the adequate legal instruments is a process that does not come over night but may easily take a decade.

Secondly, regulation is a sort of institutional engineering that (re-) allocates economic resources and power. It is, therefore, a highly sensitive political issue. Ideally, the regulatory process achieves the fair balance between the interests of consumers, service providers, investors, and the government. This requires an institutional environment characterised by capable organisations representing these interests, transparent and rules-based consultation processes and an accountable regulator. However, most developing countries lack capable consumer advocacy organisations, politicians regularly intervene directly in the regulatory process, and regulatory decisions and justifications are rarely published. This reduces faith that the public have in the regulatory process and makes it hard to achieve the objectives of the regulatory state: to promote investment, to protect consumers and to achieve efficient and sustainable infrastructure services. Or, put another way: there is a considerable risk that regulation is used to the particularistic benefit of some politicians and monopolists, but to the detriment of society.

To conclude, efficient regulation is a central issue for developing countries. However, the potential benefits of regulations hinge on the conditions of a capable regulatory state and an adequate institutional environment. In many developing countries these conditions are not given. Therefore, the central challenges are: (1) Building regulatory expertise, (2) improving the accountability and integrity of regulators and inspectors, (3) encouraging the formation and training of consumer advocacy and business organisations, (4) improving the transparency of consultation processes, and (5) overcoming vested interests that benefit from bad regulation.

Overlooking this and using the renaissance of the regulatory state as an opportunity to simply tighten regulation without changing anything else, will very likely just further kleptocracy, bad service and underdevelopment. On the contrary, facing the challenges needs determination and perseverance, but will result in long term benefits for society.

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