



Implementing Regulatory Reform

Foreign
Investment
Advisory
Service

Competition as a Substitute for Regulation: Where it is Feasible, Advisable and Beneficial

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Introduction

Policy-makers in many countries have recently been more inclined to adopt market friendly reforms. This Note suggests that, given developments in economic theory, organizational methods, and technology over the past two or three decades, competition can substitute for economic regulation in more situations than is commonly recognized. We re-visit why certain economic activities became regulated, and why over-regulation of economic activity has tended to occur in some cases – with adverse and unintended consequences for not only whom the regulations were intended to benefit, but for society as a whole.

'Market failure' rationale for regulation

Effective competition in markets may fail due to situations of '*natural monopoly*' where, due to technology, large outlays of investment, and high ratio of fixed to total costs, one firm can serve the market at lower costs than two or more firms. Such situations were *traditionally* viewed to arise in the provision of basic infrastructure services such as power, telecommunications, water and sanitation but also in transportation. Given inherent incentives monopolies have to earn excess profits by not producing the requisite level of goods and services, governments either directly regulated prices and/or profits, or owned and operated such enterprises. However, regulation or state ownership of such enterprises has almost universally failed to deliver the promised quantity, quality and cost of services. Long waiting periods and high costs of obtaining power and telephone connections, regular water supply, reliable and affordable passenger and other transportation services have been documented the world-over. In Bangladesh, the World Bank's Investment Climate Assessment indicates that firms on average experienced 250 days per year of power outages, requiring 72% of them to purchase their own generators and incur 50% higher costs per kilowatt-hour. The median wait time for a fixed line telephone is 90 days (compared to 18 in Pakistan, 7 in China). And delays in shipping exports or clearing imports in Bangladesh ports can range between 15-25 days.

Among the several explanations advanced for infrastructure services, are poor regulatory oversight and 'organizational slack' arising from lack of managerial incentives and competitive pressures, and 'capture' of regulatory agencies by staff drawn from the industry that cater to demands of producers. The

Box-1: *Broadly defined.....*

COMPETITION refers to *independent* decision-making and rivalry between existing (and potential) business entities in terms of such factors as prices, output, market share, quality, service and/or other conditions affecting the value of goods and services in order to profitably acquire, retain and increase the patronage of clients.

ECONOMIC REGULATION refers to direct or indirect oversight and control by government of business entities, requiring *mandatory adherence* to rules, procedures and other measures over such matters as prices, output, entry, ownership, investment, or factors affecting the supply, demand and consumption of goods and services.

Economic regulation requires creating a specific office or agency, and expending administrative and other resources to organize the production of goods and services whereas under competitive conditions, economic activity is organized by the free inter-play of demand and supply — what Adam Smith termed as the 'invisible hand'. However, just as not all economic activity needs to be regulated; effective competition may not be possible in all situations. See discussion on 'market failure'.

problems become compounded by 'creeping regulation' — i.e., extension of regulation to economic activities that do not display characteristics of natural monopoly. For example, while the distribution grid in the transmission of electricity may be a natural monopoly, this does not apply to power generation or wholesale and retail aspects of electricity supply. The same analogy applies to sale and supply of telecommunication equipment, long distance vs. local telephony services, fixed line vs. mobile communications, internet connections and various value-added services. Usually introduction of cost-savings and new, innovative products and services get prevented by vertical and horizontal control, cross-subsidization, and regulations preventing firms from interconnecting to supply alternative competing services. 'Unbundling' segments of regulated economic activities that do not display natural monopoly characteristics makes it feasible to inject competitive discipline in the market for many of these services. The segments that remain natural monopolies can also be subjected to competitive pressures by a variety of ways such as periodic bidding for the 'monopoly franchise' with certain investment and other performance requirements. Bidders that are more cost-efficient have a chance to profitably displace the non-performing enterprises. Such approaches do not eliminate but minimize regulation of economic activity.

Studies on regulation show differential costs. For example, in the case of the U.S., in railroads regulations hurt both producers and consumers, whereas regulation of telecommunications and cable TV hurt mainly consumers. In airlines, deregulation has yielded significant benefits to consumers, but producers have also gained. In the case of India, the relaxation of entry regulations in domestic air passenger travel has enabled airlines such as Jet Airways, Sahara and Air Deccan to offer air services at lower fares and more convenient schedules. The increased competition has also pressured the government owned Indian Airlines to improve its performance. Jet Airways is now evolving into an international carrier with competitive services to Southeast Asia, UK and USA. The entry and competition from foreign banks has similarly forced the nationalized banks in India to be more responsive to consumers and offer new products and services. Such examples also suggest that, other things being equal, it is competition and not ownership structure of firms that is more likely to improve firm performance.

Regulations may also be imposed due to other

forms of market failures, e.g., *negative externalities* arising from noise and air pollution, which require governments to set strict standards in order to protect the environment; or *asymmetric information* between producers and consumers e.g., in the food and health care industries. In markets for what are termed 'experience goods', individual consumers are not in a position to be able to evaluate the quality and attributes of particular products without significant risks to themselves — the 'experience' could be deadly. Mandatory inspection, testing and certification of the firms and the products are fully warranted. Also in financial services such as brokerage, insurance, and deposit seeking institutions, thus necessitating mandatory information disclosure requirements. However, depending on particular situations, a balance can be struck between costs of regulatory compliance and benefits of market determined incentives.

Economic regulations also get extended for various *social-economic-political* objectives e.g., provision of affordable housing by imposing rent controls and providing low cost housing finance; protecting domestic industry and fostering import substitution by imposing quotas and tariffs; agricultural subsidies to farmers; ceilings on land ownership, etc. Such interventions, while well intended, tend to create economic distortions, misallocate resources and often have opposite effects. For example, the automobile industry in India was heavily protected between 1947-1991, and was noted for producing low quality obsolete models at high prices and long waiting periods. With investment liberalization, the country is emerging as a global player and, according to McKinsey, Indian automobile manufacturers have now reached 94% of best practice productivity levels. The demand for well trained labor also increased, as did wage rates and total employment.

Demand and supply of regulation

People and firms demand regulation that makes them better off. Politicians and bureaucrats supply regulation, either to appeal to the voters and/or to wield bureaucratic power and maximize administrative budgets. The interaction between demand and supply for regulation can also result in corruption and bribery, not only to the detriment of consumers, but to society as a whole. Instead of 'public interests', 'special interests' prevail. Producer interests conflict with consumer interests and since the political process cannot satisfy both, the highest bidder gets the regulation it wants — usually producers as they tend to be fewer and better organized than individual consumers. Entry and invest-

ment by new firms is prevented or made difficult – incumbent firms rarely become competitive under such conditions in their own markets or internationally.

Alternative and more efficient approaches to meeting social-economic-political objectives are feasible. For example, instead of limiting the number of firms that can import rice and providing general subsidies (only four firms are licensed), Malaysia could liberalize imports and provide vouchers or tax credits to consumers with incomes below

Box-2: Economic “Sophisms”

Frederic Bastiat (1801-1850) wrote satirically a: “Petition” to Honorable Members of the Chamber of Deputies by Manufacturers of Candles, Tapers, Lanterns, Sticks, Street Lamps, Snuffers, Extinguishers, And from Producers of Tallow, Oil, Resin, Alcohol, and Generally of Everything Connected with Lighting...for Protection from the Relentless and Unfair Competition from the SUN.....Floods the Market with Light the Minute it Appears.....and Sales of our Products Cease Immediately.....”

Bastiat in his ‘petition’ not only highlighted the *Demand and Supply for Regulation* but also on the interconnected nature of markets. Distortions in one market ripple over to other markets and inevitably, if there are ‘winners’ in one industry, there are ‘losers’ in others. Government policies to control imports and/or steel prices may benefit domestic producers but will adversely affect users such as auto manufacturers, and construction industry. The sure losers are ultimate consumers of products embodying steel as an input. By engaging in such interventions, governments in effect arbitrarily assign values to goods and services and make what economists term as ‘inter-personal comparisons of utility’. Why should a dollar or rupee in the pocket of a ‘producer’ be given greater weight than that of a consumer??

a certain level.

In all situations of demand-supply for regulation, there are ‘winners’ who usually tend to be well or politically connected firms, and ‘losers’, namely consumers and society as a whole. In framing regulations, it is advisable to conduct cost-benefit analysis, so that one can gauge the true costs of various government regulations and policy interventions. Who should conduct such analysis?

Instruments for fostering competition

There is generally no ‘focal’ point within government that conducts competitive assessments, regulatory reviews and impact analysis, and suggests policy options that least distorts market effi-

Box-3: A Chicken in Every Pot....??

In 2000, with relaxation of trade restrictions under the WTO agreement, there was increase in imported chicken leg quarters into India from the US. However, the President of the Broiler Coordination Committee launched an antidumping action resulting in a levy of 100% duties. The same Committee convinced the government to stop the export of surplus maize....a feed stock for poultry...because the export price was lower than the domestic price with an offer to take-up part of the surplus.....while simultaneously argued (successfully) for removal of the 15% tariff on imported maize and a freight subsidy for poultry exports. While through these actions the poultry industry reaped benefits..... consumers definitely, and maize growers probably, lost out. (Source: Poultry Solutions.Com/News)

Antidumping actions run counter to policy measures seeking to foster liberal trade....protect producers at the expense of consumers. While industrial economies such as US, EU and others heavily engage in antidumping actions against each other as well as against developing nations, in recent years there has been marked increase in such actions by developing countries such as India...

ciency while balancing other socio-economic-political objectives.

Just as various self-serving special interest groups demand regulations, politicians and bureaucrats within various ministries and departments also vie against each other to gain power, prestige, and larger budgets and staff. While industries have constituencies, dispersed consumers do not. One agency in government — competition authority — is in several jurisdictions that have enacted specific legislation to protect and promote competition, are playing the role of competition advocates. The success of such agencies depends on the legislated powers, resources and staff capabilities, and institutional design such as independence from political interference.

Among the successful examples (excluding industrial countries) are the competition offices in Brazil, Korea and Mexico. In Korea for example, the Fair Trade Commission was charged with the responsibility of the regulatory review process, which led to the review of more than 40,000 regulations, decrees, and ordinances. While ‘natural monopolies’ are a form of market failure — so are anticompetitive business practices stemming from private monopolies and oligopolistic market structures. Indeed, often due to public policies such as licensing, price controls, tariffs, ‘reserve lists’ and other government regulations limiting entry, anticompetitive business practices tend to arise. Hence, one role of a modern competition agency is not

only to prevent illegal anticompetitive business practices and restraints to trade by private sector firms, but also to engage in 'competition advocacy' for removal of unnecessary regulations adversely impacting on competition and entry.

In South Asia, Bangladesh and Nepal have not enacted a framework competition law. In India, the new Competition Act was passed in 2002 but its implementation has been bogged down by legal challenges because of inadequate attention to having in place a system of checks and balances. However, initiatives are underway to conduct 'competition assessments' of various sectors with the view towards engaging in competition advocacy. In Pakistan, the Monopolies and Restrictive Trade Practices Ordinance has been enforced since 1971, but with uneven results. The resources and capabilities of the Monopolies Control Authority need to be upgraded, and the legal-institutional framework strengthened.

Other measures to foster competition and entry, and reduce the need for, or economic distortions induced by government regulations is to conduct periodic regulatory reviews and impact analysis. Many regulations tend to persist beyond their need and usefulness. Having such policies with built in 'sun-set clauses' provides for such reviews.

Given the inherent conflicts of interest, distribution of power, lobbying by various stake-holders, measures that ensure 'checks and balances', accountability and transparency in government-business relations and decision-making is critical. Without requirements as registration of lobbyists, public disclosure of political party contributions and related financial information, competitive bidding for government contracts, simplified administrative and business registration procedures, and the like, fair competition and entry will be impeded.

Conclusion

Regulation of economic activity in several spheres has tended to be more extensive than necessary. In part this situation has arisen because changes in technology, advances in economic theory and organizational methods, and 'capture' of regulatory bodies, calls into question the original rationale for regulation. In other instances, excess demands for regulations to limit competition by self-serving stake holders, and excess supply by politicians and bureaucrats have resulted in unnecessary regulatory expansion. Through independent 'competition advocacy', regulatory reviews and impact analysis, and other measures to ensure checks and balances, accountability and trans-

Box-4: *Monopolistic market structures and anticompetitive business practices*

According to financial news reports, there is unfettered consolidation and monopolistic control taking place in several industries in Bangladesh. One or two enterprises control 75% or more of the markets for cold roll corrugated sheets, edible oil, soft drinks, tobacco, glass products, sugar, and frozen food among others. Concerns have been expressed by various corporate executives on the reduction of competition in the relevant markets, but also on concentration of loans by financial institutions to the large industrial groups. However, Bangladesh does not have a competition law in place where consumers, be they individuals or firms (that buy products as inputs), can seek relief from anticompetitive business practices. This gap in the government's economic framework policy may prevent the benefits of structural, trade and investment reforms. Experience in other countries suggests that it is very difficult for new entry and competition to emerge in sectors dominated by large incumbent firms, and in absence of effective competition, such firms further entrench their market position. Trade and investment liberalization measures are insufficient to mitigate the problem.

parency in government-business relations are advisable.

However, more than a passage of a competition law and creation of a competition agency is required. It must be accompanied by a system of checks and balance, insulation from political interference, capable staff and institutional design, and the like.

There are now over a 100 countries that have adopted competition laws — the majority, mainly developing and emerging market economies, during the past decade — as part of their economic framework policies. Countries in South/Southeast Asia have generally been lagging behind in embracing competition policies.