Politics Triumphs Economics?

Political Economy and the Implementation of Competition Law and Economic Regulation in Developing Countries

– A CURTAIN RAISER

EDITORS PRADEEP S. MEHTA • SIMON J. EVENETT

25 years 1983 2008 CUTS International

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PUBLISHER'S NOTE

CUTS along with CUTS Institute for Regulation & Competition (CIRC), have envisioned a biennial research programme entitled, 'Competition, Regulation and Development Research Forum' (CDRF) on political economy of competition and regulatory issues in developing world to stimulate research, deliberations and advocacy on political economy constraints in implementing effective competition and regulatory regimes in developing countries. The first cycle has come to an end with the release of two research volumes, entitled, 'Politics Triumphs Economics?' which contains 10 papers in the first volume and 9 papers in the second volume.

A wide range of issues have been captured in the two research volumes – for instance, the political economy underlying the implementation and enforcement of competition and regulatory laws and regimes, barriers posed by vested interests to the free and fair functioning of competition and regulatory regimes and the often choppy relationship between competition enforcement agencies and regulators attributable to functional overlap which often delays decisions and is, therefore, detrimental to the welfare of any country.

An important finding is that there is a lack of positive association between affluence and independence of regulatory authorities. Thus, the research volume makes a significant contribution to raising awareness about regulatory challenges facing developing countries and suggesting appropriate means to address these.

This booklet, A Curtain Raiser, contains the Foreword written by Supachai Panitchpakdi, Secretary General of United Nations Conference on Trade and Development; Preface by Pradeep S Mehta, Secretary General, CUTS; and an Introductory chapter by Mehta and Simon J Evenett, Professor, International Trade & Economic Development, University of St. Gallen, Switzerland. The purpose of this booklet is to introduce the reader to the full report, which is available in two volumes. The first volume can be procured from the Academic Foundation, and the second volume can be accessed at http://www.circ.in/pdf/PoliticsTriumphsEconomics-Vol2.pdf

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FOREWORD

The political economy of regulation has been examined with extensively in economic literature from both theoretical and empirical standpoints. Economic theory recommends correcting market failures through regulation as a means to maximise total welfare. National realities, however, often constrain policymakers in their efforts to address market failures and maximise national welfare. The sheer magnitude of regulatory challenges facing developing countries is frequently overwhelming so that there remains a huge gap between the regulatory options suggested by economic theory and what is achievable in practice. Bridging this gap is a major challenge that necessitates sustained collaboration between experts, policy makers and regulators. In this process developing countries can benefit from information on the experiences of other countries, and advice and cooperation from different sources regarding the room for manoeuvre to adopt and adapt their regulatory regimes and to pursue international cooperation in this area. Conditions prevailing across different countries differ widely such that uniform prescriptions, remedies or recipes are not feasible.

The task facing developing countries in designing and applying regulatory regimes is not an easy one given the political economy constraints in regulatory regimes. There are real issues which need to be deliberated upon and resolved to tailor regulatory regimes to country specific circumstances so as to maximise the benefits of such regulation, minimise the costs and be administratively feasible. Not least, decisions have to be taken on the approach and substantive content of competition laws; how much administrative discretion there should be in enforcing competition laws; what might be the possible trade-offs between the objectives of economic efficiency and public interest and how these should be resolved; how related areas such as consumer protection and sectoral regulation should be addressed in a compatible and coherent manner substantively and administratively or what should be the division of labour between these agencies, the courts and political authorities; and what would be the appropriate structures and organisation of such agencies in order to

maximise their expertise, independence, accountability, political support and overall effectiveness.

The papers contained in these volumes by the Consumer Unity & Trust Society (CUTS) research project on "Competition, Regulation and Development Research Forum" provide a useful and practical guide to addressing some of the difficult issues in designing and applying regulatory regimes. They examine the political economy of the enforcement of competition laws, the regulatory regimes and the implementation of sector-specific regulation, including issues of ownership and how it might influence performance. The often uneasy relationship between competition authorities and economic regulators is also considered. Sector-specific and general case studies are also presented. As is rightly underlined in the different contributions, political will is a key factor determining the successful adoption and effective implementation of competition laws and economic regulation. These papers were presented at an international symposium on 'Political Economy Constraints in Regulatory Regimes in Developing Countries" organised by CUTS in New Delhi, India in March 2007. I was privileged to inaugurate the conference, which attracted experts from around the world.

In fact for many years United Nations Conference on Trade and Development (UNCTAD) has promoted the development benefits of competition law and policy, adopted and implemented in pursuance of the doctrines underlying the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices that were unanimously adopted by the UN in 1980. UNCTAD is the focal point on the work on competition policy and related consumer welfare within the UN system. It has undertaken extensive analytical research on a range of subjects in this area, including sectoral regulation, promoted intergovernmental cooperation and sharing of experiences, as well as delivered extensive technical assistance and capacity building to a large number of developing countries and countries with economies in transition to elaborate and implement competition legislation and policies. UNCTAD has also carried out substantial work on consumer protection in line with the United Nations Guidelines on Consumer Protection.

UNCTAD's work on competition policy and consumer welfare was recently affirmed and strengthened by the outcome of its 12th conference in April 2008. The Accra Accord adopted by UNCTAD XII mandates UNCTAD to continue to: provide a forum for intergovernmental policy dialogue and consensus-building on competition laws and policies, including through voluntary peer reviews; carry out research and analysis in this area; facilitate discussion on

competition issues on the multilateral level, with close linkages to existing networks of competition authorities; and promote the use of competition law and policy as tools for achieving domestic and international competitiveness. Such work and advocacy promotes competition law regimes that take into account the prevailing conditions in the developing countries.

UNCTAD recognises the contribution of civil society in support of promoting development objectives through *inter alia* work on competition policy and consumer welfare. It has accordingly cooperated CUTS and other civil society groups to promote a genuine competition culture oriented towards development and to raise awareness in developing countries about the benefits of competition policy for consumers for economic development in general and for the realisation of internationally agreed development goals including the Millennium Development Goals.

I am thus pleased to commend this CUTS publication for the fresh and insightful consideration of regulatory issues it brings. The first and the second volume make a signification contribution to raising awareness about regulatory challenges facing developing countries, and how to address them. It will further strengthen our joint effort to help developing countries introduce and adapt regulatory regimes and pursue international cooperation that maximises the welfare of their citizens and the world at large.

Supachai Panitchpakdi
Secretary General of UNCTAD

PREFACE

Since the 1990s developing countries have been very busy in the policy space enacting competition laws, introducing competition policies and modernising or putting in place regulatory regimes and laws. This trend obviously results from the dawning of a realisation that fair and free play of competitive forces and regulation of anti-competitive forces is the way through which optimal growth and efficient output and prices can be attained.

Given the fast pace of such developments in competition and regulation on the policy front, it seems strange that very little research on the peculiar problems facing the competition and regulation regimes in developing countries had taken place till a couple of years back. Much of the effort in competition and regulation in these countries had focused on capacity building along developed country lines to meet the requirements of new competition and regulatory regimes which in effect amounted to putting the cart before the horse. For the problems confronting these regimes were peculiar only to developing countries! Moreover, no attempt had been made to obtain a clear picture of the problems – a task which had to be accomplished before the capacity which was supposed to tackle these was put in place!

Realising the institutional difficulties that hinder the enforcement of competition and market regulatory regimes in developing countries (their low levels of income leading sometimes to conflicting welfare objectives, peculiar political economy considerations emanating from the presence of conflicting multiple lobby groups etc.), CUTS decided to fill the vacuum in research on political economy and institutional problems facing competition and regulatory regimes with the Competition, Regulation and Development Research Forum (CDRF). In its endeavour it received encouragement from international bodies/donors, such as International Development Research Centre (IDRC), Canada and the Department for International Development (DFID), UK.

Continuing Platform

The CDRF was and continues to be a forum for doing research on the problems confronting the competition and regulatory regimes of developing countries. However, unlike academic research forums it does not just stop at generating the results of research – it uses symposia and simple policy briefs to disseminate the results of research to a wide array of stakeholders including experts, policy makers, media and the common man with the objective of appropriately influencing the framing and implementation of competition policy and regulation.

The first volume and the second one are compilations of 9 and 10 papers respectively which were presented at the symposium marking the culmination of the research efforts of the 1st research cycle of CDRF. The research papers covered the experiences of a wide range of developing countries as seen mainly through the eyes of developing country authors. Importantly, rigorous analytical techniques were used to draw generalisable policy implications, which were later on also communicated to a vast and heterogeneous audience of stakeholders in a simplified form through policy briefs and online forums.

Multi dimensional Problems

The agenda for the 1st research cycle was structured to capture the multi-dimensional problems facing the competition and regulation regimes of developing countries and this feature is reflected in these two volumes of selected essays. An effort has been made to capture as wide a range of issues as possible – for instance, the political economy underlying the implementation and enforcement of competition and regulatory laws and regimes; barriers posed by vested interests to the free and fair functioning of competition and regulatory regimes; and the often choppy relationship between competition enforcement agencies and regulators attributable to functional overlap which often delays decisions and is therefore detrimental to the welfare of any country.

Moreover, these papers have been written from different perspectives and have used different methodologies. The perspective varies from 'economic' to 'legal' with some papers treading the middle ground. Methodologies vary from being purely analytical to being based on sophisticated economic theory to deriving their findings from quantitative techniques such as econometrics and game theory. Such methodologically rigorous papers are backed up by a set of more descriptive sector-specific and other case studies. These describe either the competition regime or law in a particular country or the recent regulatory experience in given sectors in different countries.

Emphasis on Implementation Aspects

A distinctive feature of these two volumes, apart from these being the first to expound the problems confronting competition and regulatory regimes in developing countries, are their strong emphasis on the implementation aspect of policy and law rather than just its content. The practical utility of these volumes is also highlighted by the fact that they deal with the problem of structuring political incentives so as to obtain competitive outcomes. It is this orientation and emphasis on practicalities rather than elegant but often inapplicable theory, which makes these volumes stand out as seminal contributions to the literature on competition and regulatory issues.

Prioritisation

Several findings come to light through the volumes which could not have been anticipated otherwise. A very fundamental result stresses the influence of vested interests on competition and regulatory agencies in developing countries with the recommendation for a wide implementation of a competition policy of moderate intensity to tackle such vested interests. The plea for moderation and gradualism makes sense as any attempt to upset the political applecart too drastically might be counterproductive.

Another major recommendation emerging out of the papers in these volumes is the need for competition agencies to prioritise their case work, given that the financial resources and human capabilities at their disposal are limited. Through a finding that is quite heartening yet another paper brings to light the lack of positive association between affluence and the independence of regulatory agencies (which is a much desired quality), the latter being more affected by the age of the regulatory agency. This finding offers much hope for developing countries which are still new to regulation in many sectors.

Yet another important finding relates to small economies; an optimal level of competition exists in the case of such economies as too much competition might impede the achievement of economies of scale. In addition to such general findings, case studies such as those of banking in Bangladesh and the electricity sector in India provide specific recommendations for the stimulation of fair competition. All these results bring to the fore the utility of these volumes not only to scholars of competition and regulatory issues but also members of the policy community, media and civil society organisations who deal with the practical side of such issues.

Building Research Capacity in Developing Countries

What is not apparent from an inspection of these volumes is that their genesis has spawned an entire new generation of researchers in developing countries working on competition and regulatory issues. Many of these researchers should continue to be the flag bearers of such research in developing countries for years to come if they are provided with the necessary support and encouragement. Thus, this cycle has helped to generate a mass of human capital which can with a little more encouragement form the basis of a self sustaining research network on competition and regulatory issues. While focussing on developing country researchers through the CDRF, care has been taken not to neglect the researchers from developed countries who are interested in the problems of developing countries. This is because parallels between the development experiences of developing and developed countries do exist despite their considerable differences; what is or was useful in the latter can with suitable modification prove to be useful in the former.

While the volumes are a comprehensive collection of papers on the competition and regulatory problems facing developing countries these have just marked the beginning of a research effort which still has a long way to go. This is because of the fact that regulatory and competition policy/laws/agencies are still in their infancy in developing countries even though their brief history has already thrown up a rich mass of data and information which yields a treasure-trove of implications for policy. The point, however, remains that much of their critical history remains in front of us. It is, therefore, necessary that their future history continues to be studied with as great an interest as their past has been examined by the contributors to these pioneering volumes. CDRF itself continues to exist and CUTS plans to bring out volumes through this forum in the future which will investigate the root causes that determine the state of the world in terms of competition policy and law highlighted so well by the first volume. The future course of the eventful path traversed by this forum would, however, depend not only on the initiative displayed by CUTS but by the support and good wishes of the entire international policy community.

Pradeep S Mehta
Secretary General, CUTS International

INTRODUCTION

Pradeep S Mehta and Simon J Evenett

With the shift away from state ownership of national industries and direct interventions in commerce (through price controls, licensing, etc.) market forces have been given greater sway in determining resource allocation. This shift has been particularly pronounced in developing countries and is significant given the potential impact on product prices, payments to labour and capital, and economic growth; all of which have implications for attaining important social goals, such as poverty reduction. A recognition of the greater role that markets can play has not, however, led to the complete abandonment of state intervention. Instead, legitimate concerns about market power, other sources of market inefficiency, and social (i.e. non-efficiency-related) priorities have manifested themselves in new forms of regulation, including competition law and sectoral regulation, which are often implemented through state agencies that are (at least on paper) independent from central government *(Mehta 2006)*. Indeed, by some estimates over 100 jurisdictions have enacted competition laws, many within the last 15 years. Moreover, in recent years, regulatory reform has been an important focus of policymaking in developing (and, for that matter, in industrialised) countries. These developments have placed a premium on understanding the factors that lead to effective and efficient sectoral regulation and competition law enforcement.

As soon as consideration is given to the practicalities of enacting and implementing competition law and sectoral regulation it becomes apparent that actors in the political arena – be they government officials and ministers, firms, and civil society groups, such as consumer organisations, may well shape outcomes, potentially profoundly. Proposals for new forms of market regulation and associated reforms must, therefore, pass through a political filter. This creates a complication in that there is likely to be a two-way relationship between regulatory intervention in markets and the dynamics that unfold in the political arena.

On one hand, corporate, bureaucratic, and sometimes consumer interests may seek to influence the terms upon which such regulation is enacted and enforced; the former being often motivated by the desire to preserve or create rents or other benefits for themselves.

On the other hand, the very implementation of efficiency-enhancing and pro-competitive market regulation may erode supra-normal profits (rents) and therefore the capacity of certain vested interests to influence political leaders, the press, etc. On this latter view, the relative strength of different vested interests over time may be influenced by the implementation of competition law and sectoral regulation, which, in turn, has knock-on effects for future political debates about market-enhancing reforms. Moreover, *a priori* there is no reason to believe that this two way relationship is less important in developing countries than in industrialised countries, and visa versa.

Going beyond the debates over the merits of promoting competition in developing countries and the case for enacting market correcting regulation, the purpose of the contributions to this volume is to examine the factors which determine the manner and effectiveness of the implementation of competition law and sectoral regulation in developing countries. Drawing upon country-specific experiences, case studies, and cross-country quantitative analyses, the contributors to the first volume (and a second volume published independently by CUTS) demonstrate how the implementation of numerous regulatory measures have been influenced by vested interests, including corporate interests, bureaucratic interests, as well as other stakeholders, such as consumer organisations.

A richer picture emerges out of the two-way relationship between regulatory and market outcomes mentioned earlier, amongst other findings. The sectoral and country coverage of the studies in these two volumes is broad, although no claims are made for exhaustiveness or that the matters studied herein are necessarily representative of the entire body of developing country experience. Section 2 of this introduction provides more information on the specific contributions to each volume.

A research initiative such as this should acknowledge numerous intellectual antecedents. Perhaps the longest standing views are those of many Continental European scholars and policymakers who envisaged a very political purpose for competition law; namely, to enhance what some have referred to as 'economic democracy' by taming concentrations of corporate power and by ensuring that markets remain open for new firms to enter *(Gerber 2001, World*

Bank 1999). Measures to promote inter-firm rivalry have long been seen as altering the configuration and distribution of economic power within societies. Now-a-days, this perspective may have particular relevance to developing countries, especially in instances where dominant firms restrict access to, or raise prices of, essential commodities, with the implied adverse effects on the living standards of the people. The attention given by some contributors to this volume to the political consequences of competition law and sectoral regulation can be seen as a return to this venerable tradition and stands in marked contrast to those who solely emphasise the efficiency-improving consequences of appropriately-enforced state intervention in markets.

The factors which determine the nature and extent of regulation in developing and industrialised countries – as opposed to the effects of such regulation – has also been addressed by prior much research *(see Peltzman 1989 for a still-relevant survey of the key conceptual matters)*. Like much of the extant literature, the contributors to the first volume and the second volume reject what is termed as Public Interest theory of regulation. According to the latter theory, regulation arises to fix market failures and thereby enhances the allocation of resources within an economy. The concern here is not that appropriately designed and implemented regulation can improve resource allocation, rather that often the manner in which such regulation is introduced and enforced in developing countries is more influenced by vested corporate and bureaucratic interests than by efficiency considerations and that a comprehensive account of the nature and effects of such regulation should take these matters into account.

Advancing generalisations about the non-efficiency-based factors that shape the enactment and implementation of regulation, however, is fraught with danger. While it is true that some instances of 'regulatory capture' (either by corporate or rival bureaucratic interests) can be identified *(see Nikomborirak 2005 for evidence on the capture of the Thai competition agency)*, so much depends on the manner in which competition in the political arena takes place within a jurisdiction. For example, in economies with small populations and market size, including in particular island economies, the political and bureaucratic elites may literally be related through family ties. Moreover, when there are small numbers of established families, collusion rather than competition may be the outcome not just in markets but also in the political milieu. In contrast, in other jurisdictions the principal competition over a regulatory matter may be between government ministries and associated fiefdoms.

As an example of the latter, a number of news reports of China in 2006 and 2007, suggested that the enactment of the country's new competition law was delayed due to disagreements among three government ministries as to which would be responsible for the enforcement of the law and, therefore, which ministry would acquire the powers allowed under the new statute. While China has resolved the issue and notified its competition law, a similar situation prevails in Nigeria, which is yet to decide about the enactment of a competition law. These examples highlight the importance of non-corporate interests shaping the nature and extent of certain state interventions in markets.

Much ink has also been spilt in the literature on the independence of regulatory agencies. By and large, there is a strong presumption of the advice of international organisations and in the writings on industrialised country regulatory experience that the independence of regulators is a desirable characteristic. This is perhaps more of a reaction to the failings of ministry-led regulation than it is to the established merits of a clear-cut alternative, although evaluations of the impact of measures of independence on regulatory outcomes are growing in number.

Like other studies, a number of the country-specific and sector-specific studies in this volume imply that it is very difficult for a regulatory agency to preserve full independence from governmental or political influence. The fact that agencies have to be accountable to the public (directly or indirectly through state legislatures or government ministries) and that from time to time politicians typically determine both the budgets of and senior appointments to regulatory agencies suggests that absolute independence is most unlikely to come to pass. Instead, degrees of independence probably characterises the *status quo* and the question arises as to what regulatory officials can do and whether legislative design can ensure that the agency is not unduly swayed from its legitimate functions by external pressures. These issues have been analysed in other research projects of CUTS, which seem to suggest, that in the developing world, agencies do acquire independence over time and it is a process often influenced by the personalities involved and their inter-relationship.

With specific reference to the enforcement of competition law, many have argued that nascent competition agencies should focus on competition advocacy and pick any initial enforcement cases with particular care. Two of the studies in this volume tend to confirm this advice *(Oliveria et al and Zoghbi)* and this is said to reflect the 'political realities' facing nascent enforcement agencies. The desire to build credibility with the public and the private sector when an agency's officials are new to the task is an important consideration. However,

surely much depends on the nature of 'political realities' and on the perceived anticompetitive threats in question.

Moreover, the prioritisation of competition advocacy rarely addresses the question as to why a competition agency is effective in entering the political arena in this manner given the other established vested interests in an economy. In short, both advocacy and enforcement are acts that may generate reactions by other societal interests and, therefore, these acts may have ramifications in the political sphere[1].

Up to this point the goal of this introduction has been to state the overall purpose of this volume (and its companion) and to situate this research initiative *vis-à-vis* both policy developments in developing literature and the relevant extant literature and policy advice. In the next section of this introduction some further thoughts on the relationship between market regulation and political dynamics are discussed. These observations also highlight the care that must be taken in drawing conclusions, including policy recommendations, from the types of study contained in the first volume.

It is hoped that these remarks will facilitate interpretation and evaluation of this study and perhaps inspire further analysis. Section 2 of this introduction summarises the papers included in the first and second volume organising them into four broad, but inevitably somewhat related themes. This latter section also describes the scrutiny to which the papers included in these two volumes were subjected before being accepted for publication.

Thinking through the Nexus between Market Regulation and Politics in Developing Countries

The purpose of this section is not to advance a general, or indeed a particularly new, theory of the relationship between regulatory and market outcomes and political factors. Instead, the goal is to offer a number of observations about this relationship that are prompted by the contributions to this volume. These observations also relate to the lessons that can be legitimately learnt from studies of regulatory interest in developing countries and may be of interest to policymakers and government officials and not just to scholars.

The starting point surely in any analysis of the regulation-politics nexus is to be clear about each term's meaning. Regulation is not just taken to be the enactment of the associated law or administrative rules but also its subsequent administration, funding, execution (including potential enforcement action),

and potential reform. Thus, the multi-faceted nature of regulation has temporal components, legal elements, and administrative facets. One might not just be interested in the form of regulation but also in its effectiveness, which itself can be defined in a number of ways.

For instance, a regulator may be seen as effective if it's actions attain the objectives laid down in the law governing its creation; if it makes a substantial contribution to accept developmental objectives such as poverty reduction, and reductions in waste (or improvements in the efficiency) in the allocation of resources; if the regulator's actions meet either the government's needs or the goals of influential elements of societal opinion; if the regulator's actions compare well with the records of other regulators in the same jurisdiction or with similar regulators in peer nations; or if the regulator's actions sustain support for the current regulatory structures or for its enhancement. These considerations imply that effectiveness is not just a matter of *what* (that is, of metrics including those of potential efficiency) but effectiveness as seen by *whom*. Moreover, the numerous potential metrics may well account for different perspectives taken on the performance of any one indicator and it is perfectly legitimate to discuss which metrics are most appropriate for a given regulator.

With respect to 'politics' our interest here is typically in the factors that ultimately influence the decisions taken (potentially collectively) by senior officials (appointed, elected, or otherwise) concerning the various facets of regulation. The emphasis on factors reflects the potential endogeneity of official decision-making, each official potentially being influenced by the actions of non-officials and by the motives and actions of other officials. The endogeneity of official decision-making opens up the possibility that others may seek to attain in the political arena what they could not accomplish easily (or at low cost) through the market system. Or, that some resort to the political arena to prevent their coveted market position being eroded. The latter two considerations speak to the interests of non-officials, however governmental decision-makers have ends of their own that could include discouraging discontent (which might be triggered by rising prices for essential commodities, for example), re-election, so-called empire building, or even self-indulgence. In such cases regulatory form and implementation may be 'exchanged' for support and favours to political leaders and related parties.

Once it is appreciated that the amount of funds that the private sector has to potentially support official decision makers is a function of market outcomes (for instance, firm support for political parties can be funded out of any supra-normal profits made) then the potential two-way relationship between

regulations and outcomes in the political arena becomes clear. This complicates matters as it suggests that regulatory form and implementation, market outcomes and political decisions are *jointly determined*. This has an important implication, namely, that emphasising the relationship between any two of these three variables might well omit potentially significant factors, in particular over the longer term when all the knock-on effects between these variables work themselves through. These considerations augur for studying and evaluating regulation in both its appropriate market and political milieu.

The fact that the sustained rents obtained by firms are often capitalised into the value of the firm or some of its underlying assets and the general discrepancy between the costs of collective action and the relatively small benefits that may derive to consumers and other smaller parties *(Olson 1965)* creates strong pecuniary incentives for rent creation and rent preservation and goes a long way to account for the limited opposition to both. In some cases, it may, therefore, be possible to envisage self-sustaining outcomes whereby government leaders create and preserve rents for select corporate interests in return for (directly and indirectly) a share of those rents or the benefits from what those rents could buy (including, for example, financial support for political parties or other favoured organisations).

The other important elements of this story are the motives of the official decision-makers (including how much they value overall societal welfare compared to the benefits that follow from various forms of corporate support), the manner in which decision-making is taken in official circles (and therefore the potential form of inter-official rivalry and coalition formation) and the technological factors and preferences that influence the magnitude of rents that can be created in the market place. These factors critically influence the two-way relationship between regulation and politics, at least as conceived in the so-called Economic Theory of Regulation advanced by Gary Becker and others and employed in this chapter *(see Becker, 1983 and Peltzman, 1995)*. In what follows, we consider the implication of this perspective for the introduction and implementation of competition law and other market correcting sectoral regulation in developing countries.

From this point of view, the introduction of a competition law that seeks to encourage inter-firm rivalry – and in so doing better align prices and (marginal) costs and ultimately better allocate resources – is an act which has potentially profound political ramifications. Advocating greater competition amounts to arguing that certain interests (that currently enjoy rents in inefficiently operating markets) should have a smaller share of national income and that those official

decision makers who have sought support from these interests should expect favours of smaller magnitude in the future. Seen in these terms it should not be surprising that some potentially significant corporate and official parties will oppose the enactment of competition laws and efficiency-enhancing sectoral regulation. However, the very fact that regulations need to be enforced after enactment provides opponents with another opportunity for emasculating any threats to their rents.

Moreover, given that a regulator's budget, the performance of senior officials, and even powers tend to be reviewed from time to time, the proponents of efficiency-based competition law and sectoral regulation face a recurring struggle to advance their goals. Worse, some of the implementation related debates may seem to others (including the media and the general public) to be far more arcane than the grand principles that motivated enactment of the relevant law in the first place; a consideration that opponents of a such law may take advantage of.

A challenge then for advocates of competition and efficiency based principles of state intervention is to devise strategies that sustain and potentially increase the support for such intervention over time. Without such support any current 'success' of an implementing agency may well be transitory, especially if that success attracts greater corporate and bureaucratic resistance in the future. These considerations imply that a comprehensive assessment of the effectiveness of state regulation requires an inter-temporal perspective and should pay particular attention to the relevant developments in the local political arena.

One factor that makes sustaining broad-based support for promoting competition principles through a cross-sectoral agency difficult is that the beneficiaries of greater inter-firm rivalry are often numerous and, on a transaction-by-transaction basis, gain little[2]. The case-specific nature of competition law enforcement almost inevitably skews the discussion of any gains away from the aggregate benefits to the specific benefits resulting from action concerning certain goods and services transactions targeted by the enforcement agency at a point in time. Unlike a tax collection agency, therefore, competition enforcement agencies are less likely to take action against a class of offenders across a range of sectors. Moreover, the small per capita gain from competition law enforcement also distinguishes it from the enforcement of health and safety laws where the gain per individual could be very sizeable (especially if injuries or death are concerned).

Finally, promoting competition has not yet risen to the status of a cherished societal value[3]; thus, enforcers of competition law cannot draw on the same deep well of support that a labour ministry can when implementing laws against the ill-treatment of immigrant workers or child labour, to name just two examples. For these reasons, advancing competition principles and sustaining support for the enforcement of competition law and other forms of market correcting sectoral regulation may be an uphill struggle in many jurisdictions.

Another consideration that follows from this perspective is the emptiness of calls for greater 'political will' to support market-improving regulation. If the degree of political support for an economic law is contingent on the manner in which official decisions are taken, the potential for rivalry between official decision-makers and the willingness of others to 'pay' for favours, etc, then 'political will' is not an exogenous, independent factor that can be conjured up. This perspective takes a pretty dim view of calls for 'leadership' and the like and emphasises the need to understand the underlying determinants of political support for efficiency-enhancing regulatory reform. Having said that, it may be the case that some official decision makers can be persuaded of the merits of promoting competition and this could influence the extent to which they are prepared to sacrifice the implementation of a competition law for some other payoff, in which case there is some advantage in seeking to inform politicians of the consequences of promoting inter-firm rivalry and the failure to do so. However, a convincing explanation would have to be advanced as to why a decision maker's preferences might evolve in response to new information and how the set of regulatory and market outcomes are affected.

Calls to promote competition are arguments that rest on the contention that some counterfactual outcomes are better than the *status quo*. Such arguments run into a number of concerns in the political arena.

First, many studies of decision-makers (in both the public and private sector) show an inherent bias towards the *status quo* or to an acute aversion to losses. Opponents to the promotion of competition can emphasise the fears and concerns and adjustments that may follow from the proposed changes which could involve job loss, unemployment, and other forms of disruption. Policymakers that particularly value social harmony may, therefore, be disinclined to support such reforms.

Second, the counterfactual outcomes sought by proponents of competition principles are based on a conception of how they think markets work, and it should not be assumed that others, including official decision-makers, share

the same views about the operation of markets. This problem may be particularly acute in jurisdictions where market forces have long been suppressed and the factors driving markets treated with suspicion. (Arguably many developing countries, in particular the formerly Communist countries and some industrialised countries, such as France, fall into this category). In sum, it is important to appreciate that the degree of support for pro-competitive regulation is contingent on the views of political decision makers on how well markets work.

Two variants of the last argument are sometimes advanced in developing countries to oppose promotion of competition and market correcting regulation. It has been contended that such initiatives would jeopardise the process of economic restructuring or, quite distinctly, the attainment of public interest goals, thereby compromising the development prospects of the country in question.

With respect to economic restructuring it has been argued that merger review regulations – a part of competition law – could prevent the attainment of economies of scale and retard firm 'competitiveness'. Supporters of merger review regulations argue that appropriately-enforced laws do not target large firms *per se*, rather such mergers or acquisitions that will generate market power and harm customers. In principle, those who doubt this defence of merger review laws either refute the suggestion that enforcement would be appropriate (which points to concerns about implementation) or conceive the working of market forces differently. In passing, it is worth noting that the evidence against this particular criticism of merger review laws is growing. It was precisely this sort of concern that led the Government of India to exclude merger review from the reform of its competition law in the early 1990s, which took place when liberalisation and opening of the Indian economy were expected to accelerate corporate restructuring.

Ratan Tata, Chairman of the Tata Group, one of India's largest business houses, has been quoted by a leading magazine as saying that when India opened up at first many firms felt that they would have to merge *(Economist 2008)*. However, numerous Indian firms quickly saw the commercial opportunities in information technology and outsourcing and adjusted their strategies accordingly. Fortunately, for India's economy, enough of its firms did not seek shelter from competitive pressures through combinations and developed their commercial advantages elsewhere[4].

Likewise, defenders of public interest goals of market correcting regulation ask whether compromising such regulation is the most effective means to attain a given public interest goal. If not, they contend, then the market correcting regulation should be left in place and the most effective form of state intervention be implemented[5]. Again, those sceptical of this logic often view the operation of market forces differently and may well conclude that adapting the market correcting regulation is the best approach. Disagreements over how markets work are probably an important factor in accounting for disagreements over policy recommendations concerning regulatory reform.

It would be wrong to conclude from the above discussion that the argument applies only to the enforcement functions of competition and regulatory agencies. The so-called advocacy functions of such agencies also pose a potential threat to not only the cosy arrangements that policymakers may have with some business interests, but also to their own fiefdoms. Proposals to provide a state body powers that enable it to publicly articulate the costs and benefits of different government regulations are unlikely to find favour with those seeking to preserve rents. Moreover, to the extent that the exercise of advocacy functions results in proposals to dilute or redistribute regulatory and other state powers, the likelihood that some government bureaucratic interests will oppose such advocacy cannot be ruled out either. A potent spectrum of interests may then be arrayed against proposals to grant or strengthen the advocacy functions of regulatory agencies.

Competition law and efficiency promoting regulation are particularly likely to face opposition when there are very close ties between the owners of entrenched incumbent firms, political leaders, and the bureaucratic elite. Nowhere is this more likely than in countries with small populations and highly unequal distribution of wealth. Here, a small number of extended families tend to be well represented in corporate, political, and bureaucratic circles, effectively discouraging members of these circles from promoting entry and other measures that may threaten profits and rents. A milder version of this argument envisages competition being promoted only in those sectors and activities where rent generation possibilities are limited. In such cases economic bottlenecks: those in ports, airports, and access to network industries, are likely to remain immune from competitive forces.

The Economic Theory of Regulation, provides a number of reasons as to why what makes sense from an economic point of view (promoting competition and market correcting regulation) might not win favour with policymakers in developing (and for that matter, industrialised) countries. Does this represent

a triumph of politics over economics? If political forces acted independently of underlying economic conditions, then that may be the case. However, market-based rents created by certain state interventions do motivate political and bureaucratic behaviour. The moral is surely that economic (i.e., technological and preference-related) and political factors jointly determine the form and effects of regulations implemented in an economy. Yet the same logic points to a number of factors which may limit the triumph of vested interests over the common will and these are described in the paragraphs that follow.

The joint determination of regulatory and market outcomes arises in part because policy makers are prepared to sacrifice some of the gains from mutual exchange to create or sustain rents for business interests. Some of these rents find their way back to policy makers. To what extent policy makers indulge in such sacrifice depends on their needs for financial and other support from the private sector as well as the existence of alternative sources of funds available to them. This suggests that there may well be jurisdictions where the electoral system is such that politicians need less support from the private sector, in which case the incidence of market distorting state intervention will tend to be less. The frequency of elections, whether parties or individuals are responsible for funding the election campaigns of candidates, the degree of state funding of political parties, and level of compensation of elected or appointed officials may have effects on the regulatory and market outcomes observed in an economy. In turn, these considerations should inform assessments of whether measures to promote efficient market outcomes can realistically be expected to go further in a given jurisdiction.

Alternatively, the appropriate benchmark for the regulatory structure in a given jurisdiction is almost certainly not zero market-distorting regulation. Furthermore, reforms to national electoral systems and the manner in which officials are compensated that reduce political needs for support from the private sector may trigger deregulation.

A related countervailing tendency is that politicians may find that they either need not or cannot create and appropriate many rents in each economic sector. In which case, the implicit bargain struck between business interests and politicians to avoid efficiency promoting regulation may be confined to a limited number of sectors and, therefore, there may be little or no serious opposition to the implementation of competition laws and the like so long as they *de jure* or *de facto* exempt the sectors, or go soft, where substantial rent generation is possible. Alternatively, those corporate practices that generate substantial rents may be exempt from the competition law and sectoral regulation (an example

being vertical agreements between firms that create supra-normal profits in distribution chains). The interaction between economic and political forces manifests itself here not in terms of outright opposition to certain market correcting regulations but in the pattern of practices and sectors exempted from such regulation and associated legislation.

A third countervailing factor is that the operation of other organised groups in society may influence the calculations of official decision makers. Even in jurisdictions where full fledged democracy is not practiced, governments may still be concerned about unrest and protest and so take into account any manifestation of discontent, whether organised or not. Two non-corporate groups, the media and organised civil society (including consumer organisations), can play important roles in this regard. It is worth bearing in mind that in countries where market forces have tended to have a bad name, profiteering firm owners are not either free from it. The media and civil society can do much to raise the (political) price paid by a politician or bureaucrat of colluding with a particular business interest, and thereby limit the extent of rent-creating regulation. Given this reality, savvy politicians may use the unpopularity of a business interest group to increase the share of rents that they can extract from the latter.

Another consideration to bear in mind is that the politically optimal structure of regulation will not be set in stone. The Economic Theory of Regulation expounded here implies that as the underlying parameters of the economy, political, and bureaucratic systems shift over time then this will create opportunities for regulatory reform and for possible retrogression (the imposition of more rent creating regulation). Changes in technologies, in the willingness to pay for goods and services, national electoral systems, the incentives for appointed officials (bureaucrats) and the set of available regulatory instruments can alter the politically-optimal structure of regulation.

In some cases, the so called convergence of technologies across sectors (as is said to be happening in data transmission related sectors such as telecommunications, broadcasting, cable television etc.) can increase the number of modes of supply, creating additional competition between suppliers and this typically erodes rents. In turn, this reduces the funds incumbent firms have to induce policymakers to favour them and the latter respond by reducing the supply of market-distorting regulation. Demonstration effects from sharp technological and other changes may provide guidance as to the likelihood of regulatory reform or retrogression in a given sector.

In sum, the purpose of the discussion in this section has been to describe and motivate the principal policy-relevant question addressed in this book: namely, to better understand the nexus between regulation (and by implication deregulation), politics, and markets in developing countries. The approach taken here draws upon the long-established Economic Theory of Regulation and emphasises the joint determination of market and regulatory outcomes which, in turn, influences development-sensitive indicators, such as the price of and access to 'essential' commodities and the pace of economic progress. In democracies and elsewhere it should be recognised that there are limits to the extent to which market failures are likely to be corrected through regulation, in particular when those failures generate rents for incumbent firms. This should be borne in mind when assessing both countries and sectoral case studies as the 'perfect' may not be attainable, in which case the appropriate benchmark may be the 'very good', irrespective of how it is defined. It was also argued that the pattern of observed regulation is not fixed over time and that technological change, evolving customer preferences, actions by civil society organisations (CSOs) and the media, and changes to electoral systems and bureaucratic incentives will shape the evolution of politically-optimal regulation over time. Undoubtedly, some of these factors are potentially influenced by external assistance and expertise. Others, however, are likely to be deeply entrenched national characteristics.

An Overview of Contributions to the First and Second Volume

The first volume is being published in conjunction with second *(Mehta and Evenett 2008)*. Both contain papers of direct relevance to the research question and matters described earlier. The papers contained in these volumes were part of the same research project and were presented at an international symposium entitled, 'Political Economy Constraints in Regulatory Regimes in Developing Countries" organised by CUTS in New Delhi, India during March 22-24, 2007. Prior to the publication, each paper was revised to take account of the comments made at the symposium and received from external experts. Considerations of size required that two volumes rather than one were eventually published.

The papers in the first volume can be divided into four groups. The first group specifically considers the political economy of the implementation and enforcement of competition laws. Everest-Phillips examines the role of competition law as it challenges vested interests that typically retard the growth process. The inherently political nature of competition law is stressed as well as its relationship to societal governance. Zoghbi takes a different tack by seeking to identify the priorities of competition agencies in developing

countries. A number of best practices are identified which, she claims, are of general relevance. The special circumstances facing competition enforcement agencies in smaller jurisdictions are discussed by Briguglio and Buttigieg in the second volume and they draw upon the experience of Malta. Nicholson, Sokol, and Stiegert provide an econometric assessment of the factors likely to generate more successful technical assistance projects in competition law and policy from 1996-2003. The effectiveness of competition law, as perceived by business people and in terms of its consequences for foreign direct investment, is assessed by Dalkir in the second volume.

The second group of papers considers regulation and its implementation. Andres, Guasch, and Straub examine whether measures of regulatory governance influence the performance of affected sectors in a dataset compiled from Latin American infrastructure sectors. They also examine whether the ownership of firms and changes in such ownership influence performance and confirms that they do. Oliveria, Machado, and Novaes develop an indicator of the independence of a competition agency and examine whether it correlates with levels of development, finding that it does not. In different ways these papers shed light on the impact of regulatory characteristics on societal measures of interest, while trying to appropriately control for other relevant factors.

The (often uneasy) relationship between competition enforcement agencies and regulators is the theme of the third group of papers. Sampson and Sampson examine whether the policy advice on how to best manage this relationship that was motivated by Anglo Saxon experience is applicable to Caribbean nations and argues that it is wanting in some important respects. In the companion volume, Shitote pursues a similar line of inquiry with respect to Kenya's regulatory regime. Karakurt and Sahbaz review Turkish experience of such matters and make three recommendations to promote effective collaboration between sectoral regulators and national competition agencies. Their study too is published in the second volume.

The fourth set of papers comprises a set of sector-specific and other case studies and they are described here in alphabetical order in the country concerned. Arun and Reaz describe the regulatory structure and corporate governance practices in the banking sector of Bangladesh and emphasises the importance of a number of political economy factors and advances policy recommendations. Defloor and Naert compare measures of the independence of the regulators operating in the Belgian economy. Their study and the next three discussed are published in the second volume. Sampson analyses the post-privatisation experience of the Jamaican telecommunications sector and highlights numerous

deficiencies in the prevailing regulatory framework. The relationship between independence, autonomy, and accountability and their manifestation in India's Competition Act of 2002 is discussed by Chakravarthy. The relative impact of ownership types and aspects of the extant regulatory regime in the Indian banking sector is examined by Datar. Kodwani elucidates the regulatory challenges facing the electricity sector in India in a chapter in the first volume. Swain examines the merits of introducing competition in India's electricity sector and concludes in a chapter in the second volume that developmental considerations should privilege the affordability of and accessibility to electricity over other objectives.

Finally the first volume contains an account of the various practical hurdles, some of which are governance-related, preventing the effective implementation of competition law and sectoral regulation in Zambia.

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Endnotes

1 See Evenett (2006) for a fuller discussion of the merits of competition agencies, especially nascent agencies, engaging in competition advocacy and an evaluation of the claims made by certain others in this regard

2 This does not exclude the possibility that aggregating across all of the agency's enforcement decisions that the average gain to each individual or firm is sizeable

3 Presumably one payoff from promoting a 'competition culture', which many supporters of competition law advocate, is that might translate promoting competition into such a cherished value

4 For lengthier treatments of the relationship between competition law and firm competitiveness see Geroski (2005) and Evenett (2007)

5 Notice that the proponents of market correcting regulation do not demote or call in question the public interest goals. Rather they contest whether efficiency-enhancing tools should be sacrificed or unduly amended to attain those goals

CONTENTS OF THE BOOK

ANNEXURE

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"...first and the second volume make a signification contribution to raising awareness about regulatory challenges facing developing countries, and how to address them. It will further strengthen our joint effort to help developing countries introduce and adapt regulatory regimes and pursue international cooperation that maximises the welfare of their citizens and the world at large".

– **Supachai Panitchpakdi**
Secretary General, UNCTAD

The last two decades have been marked by a sea change in the world of regulation – regulatory laws which facilitate the creation of independent regulators have been passed in many countries, both developed and developing. However, it has been observed that mere adoption of regulatory laws is a necessary but not a sufficient condition for changes in regulatory/economic outcomes. Implementation often constitutes the crucial difference between success and failure and this is particularly true in developing countries.

The mentioned premise constitutes the starting point of the two volumes compiled by CUTS as a part of a project entitled the Competition Regulation and Development Research Forum (CDRF), which are compendium of studies devoted to characterising the state of the world in regulation in developing countries and identifying the political economy and governance constraints that often frustrate the successful implementation of regulatory laws in the developing world. Such detailed identification of constraints is necessary if we are to solve the puzzle of how regulatory objectives/provisions that look so good on paper end up being so ineffective in practice.

It is hoped that through these two volumes the study of regulation in developing countries emerges as a distinct field, as it should, given that these countries have regulatory needs and constraints that differ markedly from those developed countries.

CUTS Offices also at Calcutta, Chittorgarh, Jaipur and New Delhi (India); Lusaka (Zambia); Nairobi (Kenya); Hanoi (Vietnam); London (UK) and Geneva (Switzerland).