Lessons from developing economies on the independence of regulators: Evidence, theory and …impressions

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Session 2:

Cross-country experiences: what works and what doesn't?

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Overview

- The context
- The evidence
- The theory
- Lessons for the debate in the UK?

The context

- **Early 1990s, the birth of regulatory agencies in LDCs (before many european countries…)**
  - *Following Argentina (1991)*
    - *often triggered by fiscal crisis…and stimulated by international donors*
  - *Strongly inspired by the British experience*
    - *huge deal for British consultants!*
  - *Restructuring of infrastructure sectors (unbundling and privatization)*
    - *Electricity, water and sanitation, telecoms, passenger and freight transport*
  - *Explosion of creations of "independent regulatory agencies" (IRAs)*
  - *Contract btw gvt and operators becomes key regulatory instrument*
    - *Sometimes supported by a sector law (energy and telecoms mostly)*
  - *Price caps dominates*

- **Early 2000s, doubts on regulatories agencies emerge and grow**
  - *Huge number of renegotiations (in particular in water and transport)*
  - *Increased politization of key decisions on tariffs, investment and subsidies*
  - *Argentina, Bolivia, Venezuela, Mali, Senegal, Tanzania, Romania, etc…revisit their position on how to run and regulate sector*
  - *Cost + and hybrids start to dominate as outcome of renegotiations*

- **So? Something went obviously wrong in many countries…**
  - *Even if in some others, still moving along and the learning process continues to varying degrees (Brazil, Ghana, India, Mexico, South Africa, Uganda, etc.*

What's the evidence that something went wrong? (1)

1. **<u>Costs were lower and efficiency higher</u> but regulators were not very effective at sharing it with users=> RENTS**
   – ***Often mostly because employment was simply cut***
2. **Sometimes <u>prices too low</u> as compared to costs, because highly politicized=>HIGHER RISKS AND LESS INVESTMENT**
   – ***Also because of lack of independence of regulators***
3. **Sometimes, <u>prices too high</u> and certainly higher than implied by costs =>AFFORDABILITY ISSUES**
   – ***But often because gvts were capturing a share of rent through higher taxes on regulated services***
   – ***And also because tariff structures did not take into account willingness and ability to pay***
   – ***Government reaction was simply to increase subsidies at a higher fiscal cost or to renegotiate to slow or cut investment obligations and some service obligations***
4. **<u>Quality often excessive</u> (wrong technology choices) => EVEN MORE AFFORDABILITY ISSUES**
   – ***Wrong due diligence before signing the contracts regulators would have to enforce***

What’s the evidence that something went wrong? (2)

Note that a lot of this, was initially impressionistic because performance monitoring was weak in most countries

- ***Huge challenge for IRAs was to make decisions without data…***
- ***=> major effort to define benchmark indicators and to rely on international regulators associations to simultaneously generate comparable data to be used by both regulators and academics***

The (sort of) good news:

- ***When data became available overtime, the story was largely validated (which is not really good news…) by research by academics and international organizations***
  - ***Initially too often too much cheering reflected in studies to avoid having to criticize too much the privatization process built-in restructuring that included the creation of IRAs***
  - ***Currently, increased polarization in research***
    - ***Matching ideology and the common personality clashes which can lead to selection biases in the coverage of the impact analysis…***

- ***And quite frankly, many EU countries face similar issues!***
  - ***…so looking how LDCs dealt with it may not be a silly exercise…***

How much could the regulatory agencies be blamed for failure or credited for success?

- Impact of IRA varied across:
  - Sectors
  - Variables of interest

- Telecoms and electricity
  - IRAs are usually good news across variables (p, q, ql and costs)
  - But
    - Planning problems and delays in key development decisions
    - hurts broadband diffusion!
    - underfinancing of transmission from tariffs (i.e. subsidies needed)

- Water & sanitation and transport
  - Huge number of renegotiation
  - Infrastructure largely financed by taxpayers for sanitation and rail and with subsidies for roads and ports

What kind of weak institutional capacity in IRAs did all the outcome failures reflect?

- **A typology of institutional weaknesses:**
  - **Limited capacity/skills to regulate**
  - **Limited accountability**
  - **Limited ability to commit**
  - **Limited enforcement capacity**

- **Plenty of stylized facts to show that these limitations were, and often still are, serious**

STYLIZED FACTS
Limited capacity and commitment

- **Limited capacity**
  - Regulators were severely under-resourced
    - …limits the effective independence of regulators
    - …increases scope for rents for firms
    - …limits ability to generate fair regulatory decisions

- **Limited commitment**
  - Political cycles impacted a lot more IRAs than they should if they has been truly independent
  - Many contracts were renegotiated…
    - …which increased risks and the cost of capital…
    - … but which reflected the lack of independence…
    - … and of checks and balances

STYLIZED FACTS
Limited accountability and enforcement capacity

- **Limited accountability**
  - Regulators (and governments) often unaccountable
    - … which explained the size and distribution of rents
  - Consultation processes are not always as effective as they should be
  - Atomization of responsibilities of key responsibilities across gvt agencies minimized individual agencies responsibilities
    - Think of transmission requirement of switch to less polluting energies
    - Easy to blame all on coordination issues
- **Limited enforcement capacity**
  - Not enough resources to do the audit
  - Not enough tools to measure and assess performance
    - Asset valuations, cost of capital, efficiency measures, regulatory accounting rules, financial models to documents trade-offs in decisions
  - High degree of political interference

Summary of how institutional weaknesses usually impacted key outcomes, largely consistent with theory…

	Quantity	Quality	Cost	Prices	Welfare
Limited Capacity	0/-	-	?	+	-
Limited Commitment	0/-	-	+	+	-
Limited Accountability	-	?	+	?	-
Limited Enforcement Capacity	-	?	+	?	-

SOLUTIONS?

	Industry Structure	Regulatory Structure	Contract Structure
Limited Capacity	Vertical disintegration More competition (?)	Less independence (?) Fewer regulators Contracting out	Lower powered incentives Simpler contracts
Limited Commitment	Vertical integration Less privatisation (?)	More independence Multiple regulators Pro-industry bias (?)	Lower powered incentives ? Less discretion
Limited Accountability	Vertical disintegration More competition (?) More privatisation (?)	Decentralisation Less independence (?) Multiple regulators Anti-industry bias	Lower powered incentives ? Less discretion Fewer cross-subsidies

What does it all mean for the UK (1)

1. Nature of institutional problem built in the design, staffing, mandate, organization or legal support to the regulatory agency matters a lot more to outcome than users, investors, regulators and politicians are often willing to recognize

2. One size fits all solution is usually a bad idea

3. Growing multiplicity of mandates (environmental, supranational, intersectoral, …)
   - makes matters a lot more complex
   - increases the case for a quantitative formalization of decisions (regulatory models, efficiency measures with multiple outputs and inputs, risk assessments, …)
   - increase in the importance of costly processes (many lesson from multiple principal, multiple agent models)

What does it all mean for the UK (2)

4. **All stakeholders need to accept that solutions to institutional challenges are going to be:**
   - **imperfect**
   - **sometimes, apparently, inconsistent with the common wisdom on what makes independence feasible and sustainable**
5. **Ultimately, independence of regulation is constrained by:**
   - **the imperfections of regulatory tools and incentives**
   - **the fact that solutions to the incomplete regulatory contracts have always been and will continue to be political….**
     - ***no matter what the level of development of the country is***
6. **The best bet to minimize the randomization of regulatory processes due to excessive politization is to increase**
   - **Transparency**
   - **Accountability**
   - **The quantification of impacts, options and trade-offs**

Thank you!