Crafting Regulation for Privatized Infrastructure

Lecture 5

11 March 2025

Objectives of Lecture

- Understand why countries need regulation for privatized firms and industries
- Examine why countries fail to regulate for privatization
- Identify the structure of regulatory institutions
- Describe the importance of regulatory commitment

Why do industries lacking competition need regulation?

- Many infrastructure activities in developing and transition economies already involve substantial competition. But others have little or none.
- For two main reasons, industries lacking competition require regulation:
  1. To ensure fair treatment of customers who lack the protection that comes with competition.
  2. To ensure that competitors have fair access to bottleneck network facilities controlled by incumbent service providers.

Crafting Regulation for Privatized Infrastructure

- Regulation plays a central role in subjecting network utilities to competition.
- Governments also have a permanent role in enforcing antimonopoly and antitrust policies, ensuring that competition is not suppressed by private monopoly power or by collusion among or combinations of competitors (Kahn 1996).
- One of the biggest challenges for policymakers in developing and transition economies is managing the shift from state ownership and control of infrastructure operations to more independent regulatory oversight.

Crafting Regulation for Privatized Infrastructure

- While some infrastructure sectors in developing and transition economies have competition, others remain monopolistic and require regulation.
- Regulation is essential to:
    1. Ensure fair treatment of consumers who lack market protection.
    2. Provide fair access to critical infrastructure controlled by incumbent service providers.
    3. Promote competition and prevent monopolistic practices through antitrust policies.
    4. Facilitate the transition from state ownership to independent regulatory oversight.

Developed countries as Role Model

- As developing and transition economies began restructuring and privatizing their infrastructure, they looked to the countries that had first taken this approach: Canada, New Zealand, the United Kingdom, and the United States.
- However, these advanced industrial countries have long traditions of market capitalism supported by strong legal institutions.
- They also have well-developed education programs that teach how to regulate private monopolies, facilitate entry by new service providers, and promote competition.
- Lacking these features, developing and transition economies have faced a huge challenge in developing effective regulation for infrastructure (Gray 1998; Noll 2000d).

Why do developing countries fail to regulate for privatization?

Regulation has rarely been adapted to the political and institutional features common to poorer countries,

1. Lack of checks and balances.
2. Low credibility.
3. The rule of law is often weak.
4. Widespread corruption and regulatory capture.
5. Limited technical expertise.
6. Weak auditing, accounting, and tax systems.
7. State enterprises in developing and transition economies were often organized to achieve political objectives, not to solve market failures.

Why do developing countries fail regulate for privatization?

Many developing and transition economies lack the institutional prerequisites for effective regulation, including:

1. Separation of powers, especially between the executive and the judiciary.
2. Well-functioning, credible political and economic institutions— and an independent judiciary (Bergara, Henisz, and Spiller 1998).
3. A legal system that safeguards private property from state or regulatory seizure without fair compensation and relies on judicial review to protect against regulatory abuse of basic principles of fairness.

Why do developing countries fail regulate for privatization?

Many developing and transition economies lack the institutional prerequisites for effective regulation, including:

4. Norms and laws—supported by institutions—that delegate authority to a bureaucracy and enable it to act relatively independently.
5. Strong contract laws and mechanisms for resolving contract disputes.
6. Sound administrative procedures that provide broad access to the regulatory process and make it transparent.
7. Sufficient professional staff trained in relevant economic, accounting, and legal principles.

Challenges in Regulating Privatization in Developing Countries

- Developing countries often struggle with effective regulation due to political and institutional weaknesses.
- Key challenges include:
  1. Lack of checks and balances, low credibility, and weak rule of law.
  2. Widespread corruption, regulatory capture, and limited technical expertise.
  3. Weak auditing, accounting, and tax systems.
  4. Regulatory institutions often serve political objectives rather than addressing market failures.
- Additionally, many lack essential regulatory frameworks such as:
  5. Clear separation of powers and independent judiciary.
  6. Strong contract laws and fair dispute resolution mechanisms.
  7. Transparent administrative processes and access to regulatory oversight.
  8. Professional expertise in economics, law, and accounting.

1) Institutional Requirement

- The structure and process of infrastructure regulation determine how effectively it supports reforms and promotes efficiency and other social objectives (Smith 1997c).
- In most developing and transition economies, such regulation is at an early stage of implementation.

2) Coherence

- Regulations for each infrastructure sector should be complementary and mutually supportive.
- The laws guiding regulation must be in agreement, and regulations must be consistent over time.
- Regulatory coherence requires that national regulators, ministries, and provincial and municipal regulators have clearly defined responsibilities.

3) Independence

- Effective regulation requires that regulators be largely free from political influence, especially on a day-to-day or decision by decision basis.

- Agencies must be objective, apolitical enforcers of policies set forth in controlling statutes.

4) Accountability

- A regulator's independence should be reconciled with its accountability.
- Allowing a regulator to set prices and quality standards gives it enormous power to redistribute rents.
- Thus, checks and balances are required to ensure that regulators do not become capricious, corrupt, or grossly inefficient.

5) Transparency

- Infrastructure regulation is an important policy issue, and in a democracy all citizens need transparent information about it to evaluate government performance.
- Thus, all regulatory rules and agreements—and the principles guiding them (and future regulation) should be a matter of public record.
- This record must be accessible to all market participants, not just service providers, to inform long-term business plans.
- Transparency helps induce investment by incumbents and new entrants—and avoid costly, time-consuming regulatory disputes.

6) Predictability

- Regulatory agencies are predictable if they follow the rule of law, particularly respect for precedent and the principle of *stare decisis*.
- Respect for precedent means that regulators reverse past decisions only if they have created significant problems.
- *Stare decisis* requires that cases with the same underlying facts be decided the same way every time.

7) Capacity

- A regulatory agency's responsibilities should match its financial and human resources.
- Available financing reflects government willingness to support independent regulatory institutions.
- Inadequate expertise is a much bigger challenge in many developing and transition economies.
- Well-developed economic, accounting, engineering, and legal skills are required for regulatory functions such as:
  - Monitoring industry performance.
  - Analyzing cost data.
  - Dealing with information asymmetries.
  - Analyzing the behavior of regulated firms.

Key Institutional Requirements for Effective Regulation

1) **Institutional Framework**

- The structure and process of infrastructure regulation play a crucial role in supporting reforms, enhancing efficiency, and achieving social objectives.
- In many developing and transition economies, regulatory frameworks are still in the early stages of implementation.

2) **Coherence in Regulation**

- Regulations across different infrastructure sectors must be complementary and mutually reinforcing.
- Consistency over time is essential to ensure legal and regulatory stability.
- Clear roles and responsibilities for national regulators, ministries, and local authorities help maintain regulatory coherence.

Institutional Prerequisites for a Successful Regulatory System

3) Independence of Regulators

- Regulatory bodies must operate independently, free from political influence in day-to-day decisions.
- Effective regulators act as neutral enforcers of policies rather than political tools.

4) Accountability

- While regulators need independence, they must also be held accountable to prevent misuse of power.
- Since regulators influence pricing and service quality, checks and balances are necessary to prevent corruption and inefficiency.

5) Transparency

- Public access to regulatory rules and agreements enhances trust in the system.
- Transparent regulations encourage investment and reduce conflicts between stakeholders.

Institutional Prerequisites for a Successful Regulatory System

6) Predictability

- Regulatory agencies must adhere to the rule of law and respect past decisions.
- Consistency in decision-making ensures stability and fairness in the regulatory process.

7) Capacity Building

- Effective regulation requires adequate financial and human resources.
- Skilled professionals in economics, law, and engineering are essential to monitoring performance, analyzing costs, and addressing information gaps in regulated industries.

The Structure of Regulatory Institutions

- The economic and technological characteristics of a regulated industry, as well as a country's resources (including human resources), will affect the institutional architecture of regulatory governance.

- Moreover, effective regulation requires both an administrative body (to execute it) and a political institution (to ensure its legitimacy; Aubert and Laffont 2000).

Centralized or Decentralized?

- Designing regulation involves tradeoffs (Smith 2000b). For example, decentralization—making lower levels of government responsible for regulating utilities—offers several advantages.
- **Advantages of Decentralization:**
  - Allows local conditions and preferences to shape regulation.
  - Moves regulators closer to services, allowing them to gather better information on users.
  - Promotes competition among subnational regulators to attract private investment (Tiebout 1956; Oates 1999).
  - May improve enforcement of regulatory decisions (Laffont and Zantman 1999).

Advantages of Centralization

But centralization also has advantages:

1. A national regulatory structure makes the best use of scarce expertise and minimizes the fixed costs of regulation (such as those of maintaining regional offices).

2. Centralization can also reduce the risks of a regulatory race to the bottom—as when jurisdictions competing for investment take on excessive financial risk or lower their environmental standards.

3. And centralization may be necessary if jurisdictions are too small to support an efficient scale or scope of operations for certain industries.

Advantages of Establishing Separate Agencies

Establishing separate agencies has advantages.

1. It recognizes the unique economic and technological characteristics of each infrastructure industry and enables regulators to develop deep, industry-specific expertise.

2. It also mitigates the risk of institutional failure and encourages innovative responses to regulatory challenges.

Benefits of Using One Regulator for Multiple Industries

- But there are also benefits to using one regulator for several industries:
  1. Doing so makes it possible to share fixed costs, scarce talent, and other resources.
  2. Consolidation also builds expertise in cross-cutting regulatory issues: administering tariff adjustment rules, introducing competition in monopolistic industries, and managing relationships.
  3. In addition, the broader responsibilities of a multi-industry agency reduce its dependence on any one industry and so help protect against capture.
  4. A multi-industry agency may be better able to resist political interference because its broader constituency gives it greater independence from sector ministers.

No single approach will suit all circumstances:

- Deciding on the breadth of regulatory coverage involves numerous considerations:

  1. In economies with a small base of consumers (not necessarily population) and limited human and financial resources.
  2. Regulators in developing and transition economies typically have less discretion than their counterparts in industrial countries.
  3. If market substitution can occur between the output of regulated industries, economic distortions may arise from inconsistent regulation of common issues.
  4. The scarcity of expertise and vulnerability to political and industry capture in developing and transition economies also strengthen arguments for multi-industry regulation.

The Importance of Regulatory Commitment

- Commitment and credibility are especially important in the restructured and privatized infrastructure industries of developing and transition economies because of the economic characteristics of these industries.
- Infrastructure industries are essential for the public and for the economy. When infrastructure service prices are based on costs, they can eat up a large portion of household budgets.
- Because infrastructure services are also essential for other economic activities, service levels and prices can significantly influence industrial costs and international competitiveness.

The Importance of Regulatory Commitment

- Infrastructure characteristics also create opportunities for government manipulation (Spiller and Savedoff 1999).
- Because many infrastructure investments are fixed and sunk, private utilities will continue operating as long as prices cover short-run marginal costs.
- Thus, once sunk investments have been made, bargaining power shifts from investors to regulators (Hart 1995).
- At that point, governments may impose special taxes, require special investments, control procurement and employment practices, restrict the composition and movement of capital, or lower the regulated prices that utilities can charge for services.

The Importance of Regulatory Commitment

1. Strong regulatory commitment is essential for privatized infrastructure in developing and transition economies.

2. Infrastructure industries are vital to both the public and the economy, impacting household budgets when service prices are cost-based.

3. These industries also play a critical role in industrial costs and international competitiveness.

The Importance of Regulatory Commitment

4. However, infrastructure characteristics create risks for government intervention (Spiller & Savedoff, 1999).
5. Since many infrastructure investments are fixed and sunk, private utilities remain operational if prices cover short-run marginal costs.
6. Once investments are made, bargaining power shifts from investors to regulators (Hart, 1995), allowing governments to impose additional taxes, enforce special investments, control hiring and procurement, restrict capital movement, or lower regulated prices.