If we think of regulation as the use of public authority to set and apply rules and standards we can consider both the regulation of business and regulation inside government itself. In developing countries the state is likely to have more responsibility for economic and social regulation than it has nowadays in developed economies. Therefore, when thinking about regulatory strategies for relatively poor countries, it’s important to include the “new public management” reforms which have been eagerly prescribed for some time now by international economic institutions such as the IMF and the World Bank.

What is needed is a wide-ranging framework that covers all the complex transactions involved in economic and social policymaking and management by the modern state. This involves looking not only at changes in the formal rules that govern relationships between the public and the private sector but also at the changing relations between the state and the market and the informal processes that influence how these changes work out in practice. Inevitably this requires us to look at the whole range of liberalisation and deregulation reforms. While these are usually seen to be driven by a philosophy that seeks to rein in the state in order to let market forces have their way, they also involve market-inspired managerial changes in how state-run activities are conducted.

The regulatory state
One form of regulation, then, relates to how the state continues to control activities which have been privatised. Another relates to how the “new public management” reforms are designed and implemented. These are supposed to remove politics from management and involve delegating managerial and institutional autonomy in various ways. Paradoxically, doing this requires a huge effort of centralised political will and creates the need for more regulation from the centre. The debate on regulation has moved on therefore from only looking at privatisation to discussing the “regulatory state”.

Although democratic states can and do delegate rule-making powers to unelected bodies they cannot delegate their own legitimacy. These bodies must remain publicly accountable. It follows that, when designing a regulatory state the key questions are:

1. To what extent will decisions be delegated to independent agents?
2. How independent will the agency be from the political process?
3. What rules will determine the agency’s procedures?
4. Should politicians be able to override the agency’s decisions?
It is obvious that this approach means not only considering institutions and policies but also the politics of regulation.

Specialised agencies can sometimes attract and retain experts better than government and a distance from government may reduce the danger of political interference. In any case, it is hard for governments to placate opposing pressure groups so it may be politically preferable to legislate on a vague principle that won’t generate much opposition and then delegate the job of drawing up and enforcing detailed rules (attracting the inevitable criticism) to an agency. On the other hand, politicians may not readily give up control of key aspects of economic decision making.

To be credible, regulators have to be accountable. Most countries have audit systems which enforce proper financial management but regulators’ procedures must also be seen to be fair, to resist pressure from private interests and to serve the public. Furthermore their rules and decisions must support the overall goals of the system.

To encourage fair procedures the usual remedy is for administrative law to be written so as to ensure that individuals and firms get a fair hearing when regulators make decisions that affect them. Regulators may also be required to consult outside interests, publish their proposals and give reasons for their decisions. Although such methods can be helpful in ensuring that pressure groups do not exert unfair political pressure from private interests and to serve the public.

To encourage fair procedures the usual remedy is for administrative law to be written so as to ensure that individuals and firms get a fair hearing when regulators make decisions that affect them. Regulators may also be required to consult outside interests, publish their proposals and give reasons for their decisions. Although such methods can be helpful in ensuring that pressure groups do not exert unfair political power over the regulators, they are time consuming and expensive.

It is traditional for professionals to regulate themselves and self-regulation has recently extended into other areas. A self-regulatory agency (SRA), with its easy access to expertise and professional knowledge, may be both cheaper and a more effective rule-maker than a public independent agency. There are obvious dangers in the SRA not being accountable through the usual channels and in the fact that it may act in the interests of the regulated group rather than a broader public interest. A judicious mix of public and self regulation where SRAs are overseen or ratified by government may offer the best of both worlds.

There is no easy way of ensuring that regulation properly pursues public interest goals. Indeed, given the recent history of aid donors’ enthusiastic prescription of privatisation, new public management and other neo-liberal economic reforms, opinion is currently sharply divided about how well or badly these policy transfers have impacted on developing countries’ growth and levels of poverty.

**Regulation and development**

Contemporary economic reforms are themselves a response to what was seen as the failure of the previous era of neo-Keynesian consensus. This assumed that the state should manage macroeconomic strategy, tax so as to redistribute wealth more equitably, control labour and money markets and satisfy social needs through state-run enterprises and state-engineered social welfare systems.

The “Washington Consensus”, actively promoted by the IMF, World Bank and US Treasury, among others, has, since 1990, demanded that the state “roll itself back” and privatised, deregulated and liberalised national economies. Stiglitz’s now famous savaging of the IMF in 1992, shortly before being forced out of his position as Chief Economist at the World Bank, drew international attention to the limits to free markets of incomplete information, inadequate markets and unworkable institutions – conditions particularly likely to apply in less developed countries. He made a strong case, not just for a gradualist approach in contrast to the “shock therapy” widely decreed by the IMF, but also for policy which recognises the uniqueness of each country’s social and economic history and culture and puts the concerns of the poor above the interests of creditors.

Stiglitz’s insider account revealed tension within the Bank between two significantly different and potentially incompatible agendas being simultaneously pursued. The first, and to date dominant, agenda is one which, in its actual effects, seems to act mostly in the interests of the international financial community and has the support of some countries’ finance ministers. A second agenda, promoted by those sceptical of the first, seeks to advance social empowerment and regulation in the social interest.

Effective development policy is not just about getting the practice right: it is about getting the ideas right. Rather than thinking of developing country states as failed service providers it might be more realistic and fruitful to think of them as “social transformation” states which have a hard job to do in steering their countries towards becoming industrialised capitalist economies. Certainly the industrialisation nation states played an active role during their own countries’ industrialisation. Accepting this involves accepting the need to understand the role of powerful social groups. Institutional reform is thus revealed to be deeply political.

**Designing the regulatory system**

What are the main characteristics of a “sensible” regulatory system? We need to consider both the instruments that are chosen to achieve the desired result and the ways these are chosen and then used. A regulatory system, to survive, must be seen as legitimate by the people it seeks to control.

Some people focus mainly on the formal and legalistic definition of how rules are made and then operated. They tend to view government as a command and control operation, entirely legitimised by the political process which mandates it to act in the “public interest”. Others dispute that there exists such a thing as an uncontroversial “public interest”.

**Public interest analysis** looks at areas where markets have “failed”, considers different ways of correcting this and predicts how people would respond in each case. It is concerned with getting the desired results as cheaply as possible and with the least time and trouble.

On the other hand **private interest analysis** looks at how regulation may not serve the public interest. Private interest advocates may prefer to meet the demands of those private groups who have an interest in influencing the regulatory process. If this is the case, then we also have to look at how the regulatory process can prevent this happening.

**Regulation – central or delegated?**

Centralised and uniform regulation is simpler for suppliers and consumers to grasp but it involves averaging citizen’s preferences over a wider area. This may result in rules that very few people actually agree with. Local authorities understand local preferences better and, theoretically, dissatisfied people could move to another area where they preferred the local rules. But local regulators may find it harder to resist pressure from local industries and, if one of them were to give in and reduce regulatory protection, there could be a “race to the bottom” with neighbouring authorities competing to please local businesses. Centralised regulation should therefore be the preferred option when people’s preferences do not vary much by area, when impacts might cross regional boundaries and when local regulators might be in danger of undermining each other’s efforts.

**How precise should regulation be?**

If rules are precise they eliminate discretion and uncertainty so are cheaper to implement. They also give agencies less power over firms. But precise rules, being inflexible, cannot be modified to fit particular circumstances and will tend either to be too restrictive or not restrictive enough.

There are three important choices when drawing up less precise rules. They could be incorporated into a general regulatory code by the legislature, a relatively transparent process but one that makes future changes difficult and cumbersome. Alternatively, legislation could contain just a general principle with guidelines and the enforcement agency could be given broad discretion in its judgements. This is a more flexible process but decisions may end up being taken behind closed doors. The third option is for an agency to be given the power to create formal regulations for individual firms. This is usually done using permits where the application process enables standards to be negotiated, a costly process which can also be abused if the details are not open to public scrutiny.

Unfortunately it is very expensive to scrutinise all applications for such permits, it is inefficient to keep applicants waiting for a result and this method can also be used to keep barriers to entry (of a market) so high as to make competition. Therefore there would need to be major benefits before we would...
chose to use this method. If the potential for disaster was sufficiently enormous (nuclear accidents say) then we might prefer to demand that firms were licensed beforehand rather than poke around in the aftermath looking for someone to fine.

The other case for licencing, often seen in the context of service provision, is when it is very difficult to assess performance so succinctly and comprehensively as to be able to set enforceable standards. In this situation case by case scrutiny may indeed be required.

**Enforcing the rules**
How then to ensure people follow the rules? An alternative to issuing permits is to set standards. In this case people are free to get on with their chosen activity but if they fail to meet the set standards they are committing an offence. Standards relate to either performance (output) or specification (input). Performance standards require products to be of sufficient quality – specification standards require the supplier to use (or not use) certain production methods or materials.

Performance standards tend to be preferable, at least for large firms, because, up to a point, firms can decide for themselves how to meet the quality standard so this encourages them to find innovative ways of doing so. Specification standards are much cheaper to administer - the agency just has to check what has or has not been used. The firms know exactly what is expected of them and what they have to do.

But what if the standard-setter is not confident that the inputs they are prescribing will cost-effectively achieve the desired ends? Even specification standards discourage innovation in that they prevent firms from developing other and maybe cheaper ways of meeting the required standard. Also they go out of date quickly.

Instead of setting standards of behaviour we could just demand that firms disclose information about the risks of being harmed by their activity or product. Theoretically, if people have all that information, they will express their preferences through their market transactions.

The main problem with this is that not everybody will get the information and not all of those who do get it will be able to use it well. The main benefit is that it is cheap and it is the consumer who has to take most of the action, including the tedious weighing-up of the pros and cons of buying the product. When getting it wrong might lead to death or serious personal injury it might make economic sense to force firms to make their products safer anyway.

As well as using the threat of sanctions to control behaviour, rule setters can use incentives such as a pollution tax. In this scenario people and firms can behave as they wish but if they choose to pollute they will be taxed. The tax should be set at the exact level of the costs of the damage the activity inflicts on others. Since the external cost of the activity is then borne by the actor, if this is happening within a competitive market, the result should be efficient production and consumption.

A big advantage of using taxes is that, so long as the agency can make a good estimate of the costs of the damage, it does not need to know how much it would cost to avoid it. Firms, once they know the size of the tax, are free to make their own decisions about whether they would prefer to pay it or change their behaviour. Also, since the tax will go up in line with the amount of damage being caused, the firms have an incentive to reduce the damage they are causing. In this way taxes seem better than command and control mechanisms such as standard setting since, under the latter once firms have met the standard there is little incentive to do any better.

All the same, if the agency does not actually know how much it would cost firms to avoid the damage, then it can’t tell how much damage will result from any particular set of prices. An iterative or “suck it and see” approach will be needed. The agency will set a tax, see how much damage still occurs, consider raising the tax and so on.

**Setting the social and economic rules**
Social regulation covers things like health and safety and environmental and consumer protection. A firm pollutes the environment or a professional activity – say being a doctor or financial advisor – may lead to people suffering health problems or financial loss. The aim of social regulation is not to prevent such losses occurring but to achieve the best possible level of losses. By definition this optimal level is achieved when the benefits that would be gained by reducing the level of loss are exactly equal to the costs that would be incurred in regulating at this level. These costs include the direct administrative and other costs of running and implementing the regulatory regime and the costs to the firms of obeying the rules.

For economists, choosing the instrument to use depends on the reasons why you want to control behaviour in the first place. They see rules as primarily methods for creating competitive conditions in markets where such conditions do not easily exist naturally. This is an important perspective on rulemaking because economists contend that this is the way to increase the size of the economy which has the potential to benefit all the people in the country, especially the poor (although of course a larger economy need not necessarily benefit the least well off at all).

Logically, you should only regulate the market if it is failing to behave the way you want it to. This might include, for example, it not being sufficiently competitive – though here we have to be careful what we mean by competition (see CRC Policy Brief #1). Another significant market problem is that suppliers and consumers don’t have the information they need to make the good, “rational” decisions that are supposed to underpin the function of the market. Further, there may be spillover effects where activities affect third parties in ways that are not reflected in the prices set by producers. And, even if you could achieve what you want purely through private transactions, it may be so expensive to organise this that you would be better off using the law.

Another good reason for regulating the market is that, left to itself, it may not distribute resources in what is seen to be a fair way. And there may be an argument, sometimes, for protecting people from themselves. Often there are already legal remedies for many of these problems i.e. people can have their grievances addressed directly without the need for the state to get further involved in regulating.

But this is not always the case. People or firms will obviously try to enforce their rights only if they expect the rewards to be worth the time and trouble. So, for example, if something negatively affects large numbers of people but only slightly then the law will not handle this well and serious misallocations will remain uncorrected. Such injustice will be even more likely if it is hard to gather the information needed to win the case or if it is dauntingly complicated and technical.

**Regulatory policy transfer**
What is missing from most accounts of regulation is an understanding of how human behaviour can only be explained if the cultural context is understood. The way power is distributed among different social groups (by income, ethnicity, locality, gender, family position, age, disability etc) varies from country to country and will have an important effect on how regulations are devised, interpreted and implemented (or not). To regulate successfully it is necessary to understand why institutions do or do not succeed and how trust can be built on locally shared values. Therefore, however desirable it might seem, it is not possible to create a regulatory blueprint that will be politically and socially acceptable (and therefore economically achievable) in all situations.

**Trust – it’s the next big thing**
“Trust is a fashionable label in current discourse, but its behavioural characteristics make it somewhat intangible.”

As we have asserted, regulation is essential both to secure efficiency and to manage risk. But to be effective, especially in complicated and difficult situations such as those faced by developing nation states, regulation depends on widespread public support. If those being regulated agree with the rules and the social norms they try to enforce, then they are likely to follow them voluntarily.

Achieving such a level of agreement depends on maintaining a constant dialogue between the regulators and those whose behaviour they seek to control. If such agreement is not reached and rules have to be imposed then people and firms...
are much more likely to try and avoid them, especially if enforcement is weak and escape from sanctions is relatively easy. It has been argued that the plethora of new institutions of performance evaluation across a wide range of public services have arisen from precisely such a breakdown of agreement and hence of trust.

**Corruption or social capital?**

In seeking to cope with this supposed crisis in social relations of trust, attention is often focused on so-called corrupt behaviour. Of course everyone interested in promoting economic growth and fighting poverty deplores large-scale corruption. However, it is sometimes overlooked that unscrupulous individuals or groups are able to cream off large amounts of money and, in many cases, remove it from the economy altogether. But we contend it is not at all helpful to adopt an over-simplistic moral crusade about much social behaviour which currently tends to be labelled as corrupt and hence considered morally and economically offensive. Instead we should treat "corruption" as a form of behaviour which has to be explained. The more persistent and widespread it is, the more we need to learn and understand in order to be better able to curb it.

The dominant stereotype of corruption is that it is a problem caused by opportunistic, selfish individuals who seize opportunities to appropriate public money for their own use. But such a narrow definition of corruption makes it difficult to explain the much more widespread, small scale "corruption" of ordinary citizens which is considered legitimate and even laudable by those involved. Anti-corruption initiatives are not likely to work if the targeted behaviour is persistently socially rooted, if the criminal justice system is itself prone to corruption and there is not the political will for an effective anti-corruption policy.

In some situations, corruption may actually facilitate effective regulation, for example when it enables processes to be carried out more speedily, but the positive effects are generally significantly outweighed by the negative effects. Therefore there are good reasons to discourage those forms of corrupt behaviour which are, on balance, genuinely harmful to the public interest.

However, if the cost of seeking major changes to deeply embedded cultural attitudes is too high, then strategies designed to deal with corruption in industrialised societies may simply be futile. If there is, for example, a very low likelihood of detecting and convicting miscreants then, in order to act as a deterrent, sanctions would have to be very big indeed, in fact unreasonably big from the point of view of the unfortunate minority who are caught and convicted.

As well as seeking to punish illegal behaviour, it is worth considering rewarding legal behaviour. It has been argued that improving officials’ salaries might to some extent alleviate the problem of corrupt behaviour. But why should high earners not be equally tempted by a bribe? Evidence to date is ambivalent on this point.

Perhaps making officials’ benefits such as pension entitlements dependent on their good behaviour might be more effective. There is evidence that, for example, relating tax collectors’ payments to how much tax they collect results in more tax being collected. But such policies may be counterproductive. If officials are rewarded better for making publicly desirable decisions they may respond by demanding higher bribes for making undesirable decisions.

If corrupt behaviour floursishes partly because it is unlikely to be detected should whistle blowing be encouraged? Unfortunately this strategy introduces the risk that frustrated bribers may use it when their attempts to enforce illegal contracts are thwarted. Also it may encourage people to threaten to frame innocent officials as a way of extorting money or favours from them.

Perhaps the most cost-effective approach is to concentrate on reducing the opportunities for corruption rather than trying to stamp it out altogether. Given that over-regulation is considered a problem in many developing countries and that many opportunities for corrupt dealing arise from regulation, a reduction in regulation may lead to a reduction in corruption. As already noted however, an effective regulatory state is probably particularly indispensable in developing countries seeking rapid social and economic change. It is important therefore not to throw the baby out with the bath water. Effective state policies on regulation are essential – but dismantling excessive regulatory opportunities for corruption is also a good thing.

Giving rule-makers more discretion offers, as does decentralisation, important potential benefits as has already been pointed out. But where accountability is weak it also creates more opportunities for corruption than do clear and precise rules. And in developing countries evidence suggest that regulation based on unwritten and informal rules leads to more corruption.

Finally there is the question of the consultation process and the drive to establish wide social agreement on rule-making and the norms that underpin it. Desirable though this is, more personal access to regulatory officials does increase the opportunity to broker corrupt deals. If there are no systems in place to make what happens in such meetings open to public scrutiny, then in some circumstances it may be better to limit such access in the interests of making it harder to achieve corrupt deals.

**Are regulatory reforms working?**

Given that many international and bi-lateral aid agencies currently actively promote the transfer of Western models of regulatory policy that link together privatisation, new public management reform and economic liberalisation, it would be irresponsible to leave the question of regulatory reform without asking whether developing countries have worked well where they have already been applied. The techniques of impact assessment are now being brought to bear on this question, at least in the industrialised nations. Regulatory impact assessment, if well designed and implemented, can be an effective way of making regulators consult widely and think through the potential positive and negative effects of any proposed rule change (see CRC Policy Brief No.3).

The evidence to date suggests that the effects of current regulatory reforms in developing countries are at least debatable. So far, it would seem that serious errors in the sequencing of such reforms have had widespread and significantly negative impacts, especially on the poor. Where privatisation has been undertaken in a hurry, under international pressure, and in the absence of good regulatory controls and competent institutions, as in Russia for example, the result has been the massive enrichment of a small elite, a flood of capital out of the country, rapid industrial decline, damage to social institutions and an enormous increase in the numbers of people living in poverty. In contrast China, where the long march to a market economy has been both gradual and accompanied by strong state support for market-based regulatory reform, has enjoyed well above average growth and the most impressive reduction in poverty levels in the world. The principal lesson for policy in this field appears to be the need to pay careful attention to the local and developmental context into which ‘best practice’ models of regulatory reform have to be inserted, and to which they must be adapted. The stakes for regulatory policy transfer could hardly be higher.