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REGULATORY IMPACT ASSESSMENT IN DEVELOPING COUNTRIES: RESEARCH ISSUES

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REGULATORY IMPACT ASSESSMENT IN DEVELOPING COUNTRIES: RESEARCH ISSUES

"Effective governments are needed to build the legal, institutional and regulatory framework without which market reforms can go badly wrong at great cost – particularly to the poor. Whilst excessive or cumbersome regulatory barriers stifle incentives and discourage investment, effective regulation remains essential – for instance, to promote financial sector stability, to protect consumers, to safeguard the environment, and to promote and protect human rights, including core labour standards".

> DFID, *Eliminating World Poverty: Making Globalisation Work for the Poor*, White Paper, December 2000, pp. 24-25.

> "Better regulation does not always mean less regulation"
> World Bank (2001) *World Development Report 2000/2001, Attacking Poverty*, p. 72.

1. INTRODUCTION

The idea of using regulation as a policy instrument for improving economic performance in developing countries has a long, but chequered history. The term 'regulation' has been defined differently (either more narrowly or more broadly) in different contexts and at different times, but can be broadly defined as "any government measure or intervention that seeks to change the behaviour of individuals or groups" (Cabinet Office, 2000a). Given that regulation is about government actions to affect non-government agents' behaviour by establishing and applying a set of rules, it is hardly surprising that the ebb and flow in the emphasis given to the benefits or costs of regulation has paralleled the much broader shift between state- and market- based approaches to economic management and development policy. Regulation therefore, has been variously labelled 'good' or 'bad' depending on the prevailing orthodoxy in development thinking at the time.

Having retreated from the extremes of market orthodoxy that were practised in the 1980s and early '90s with serious adverse consequences for the longer-term development trajection of many lower-income countries, the current orthodoxy recognises that markets are often imperfect, incomplete or missing. While the goal of economic policy remains unchanged – "achieving increased economic well-being for poor people" (DFID 2000: 9), the means of

achieving this goal has shifted, to incorporate the role of effective governance and institutions in enabling markets to function efficiently.

"Growth is essential for poverty reduction …. Growth will depend on a continuation of market-based policies which promote investment in the context of low inflation and effective macro-economic management …… The primary source of pro-poor growth will be the private sector, and particularly poor people themselves ….. It is important for the state to create a legal and regulatory framework for private sector enterprise and to maintain a commitment to pro-poor economic reform" (DFID, 2000b: 9-10).

Regulation is now seen in a more positive light, as an instrument that can facilitate private sector development and pro-poor growth. But to do so, regulation must be 'effective'. Whether 'better' regulation requires more or less regulation cannot be deduced *a priori*: it can only be determined by examining the benefits and costs associated by a particular regulation.

There is a need, therefore to subject regulations to greater scrutiny than in the past, thereby enhancing the quality of public decision-making. Regulatory impact assessment (RIA) provides a method for assessing the positive and negative impacts (benefits and costs) of existing or potential regulatory measures. Regulatory impact assessment has been widely applied in OECD countries, but there is little evidence of its use in developing countries or in organisations involved in the design and formulation of development policy.

With the renewed attention being given to regulation policy in the developing country context, there is a growing need to strengthen the capability for assessing the impact of regulatory change. At present there is an absence of even rudimentary data in many countries on the effects of regulation (Guasch and Hahn, 1999). Building capacity in the use of RIA can make an important contribution to establishing a transparent and accountable system of public policy and governance, which is correctly seen as a requirement for pro-poor growth and sustainable development.

This paper identifies two related priority research topics in the area of regulatory impact assessment. These issues, which are discussed in the last sections of the paper, are as follows:

- development of a methodology for assessing the impact of regulation changes in the developing country context

- application of the methodology to proposals for changing the regulatory framework for financial institutions in developing countries.

The other sections of the paper elaborate on the context and purpose of RIA, and on the need for financial sector regulatory change in many developing countries. Section 2 discusses regulation in the context of private sector development and economic growth. Section 3 relates regulation to the goal of sustainable development. Section 4 discusses regulatory impact assessment (RIA), the objectives of RIA, the general principles underlying the approach, and the problems associated with developing an appropriate methodology. Section 5 examines the case of financial sector regulation as an appropriate issue for which to apply to RIA.

2. REGULATION AND PRIVATE SECTOR DEVELOPMENT

In market economies the private sector is the predominant source of economic activity and main driver of economic growth. As economic growth proceeds, poverty is reduced with expanding economic opportunities for poor people through the growth in formal and informal employment.

Well-functioning markets are needed if the private sector's role in generating growth and incomes is to be sustained. Governments in most developing countries now recognise the private sector as the main engine of economic growth and acknowledged the need for public policy to enable the markets to function efficiently:

> "Markets require legal, physical and financial infrastructure to function effectively. Governments need to encourage competition and facilitate a flow of accurate information to market participants. This involves the provision of business support services to all levels of business with public sector provision where private sector companies are not active …. This will require the development of an enabling environment including appropriate legislation, regulation and utility structures, as well as significant levels of private sector investment in infrastructure and services" (DFID 2000a).

In summary, in order to create an 'enabling business environment', policy should be directed at removing the constraints that impede private sector growth and create opportunities for private sector investment and business development.

In the early period of market reform in developing countries, the main constraint on private sector development was seen as government intervention in markets which caused significant 'distortions' and economic inefficiency. To correct these distortions required deregulation and economic liberalisation, following the dictates of the 'Washington consensus'. Much less consideration was given to the design of policy to deal with the traditional economic causes of market inefficiency in terms of market imperfections and market failure.

The experience of 'market-friendly reforms over the past two decades has shown that economic liberalisation and deregulation are often insufficient in themselves to deliver sustained economic growth and poverty reduction:

> "At times, however, reform programmes have failed to deliver as much as expected – and at times reforms have failed entirely".
>
> "Not surprisingly, case studies of reform episodes show that market-friendly reforms have uneven costs and benefits – especially in the near term – with the costs concentrated on particular groups and the benefits spread broadly over the economy as a whole…. The costs remind us that success or failure is not measured only by changes in average incomes" (World Bank, 2001: 64, 66).

The lesson drawn from this experience of "market-friendly" reforms is that market-led growth requires public policy to correct the inherent imperfections in markets, which can extend into the governance and institutional environment within which markets operate – "the lessons of these failures point to the importance of designing and implementing reforms in a way that is measured and tailored to the economic, social and political circumstances of a country". (World Bank, 2001: 76)

The current consensus is that intervention in markets is required to make them work better, thereby supporting private sector development and economic growth. To argue, therefore, for economic regulation which will facilitate market entry and exit, control monopolistic practices, increase factor mobility and reduce transaction costs, is to push again an open door. Where there is much less agreement is on the question of whether the purpose of regulation

should be limited to supporting private sector development, or should be extended to broader development goals.

3. REGULATION AND DEVELOPMENT GOALS

The goal of development policy is to achieve sustainable development, which is normally understood to require long-term economic growth, environmental protection and social justice, particularly in the form of poverty reduction:

> "Development is a multi-dimensional undertaking to achieve a higher quality of life, for all people. Economic development, social development and environmental protection are interdependent and mutually reinforcing components of sustainable development" (UN, 1997).

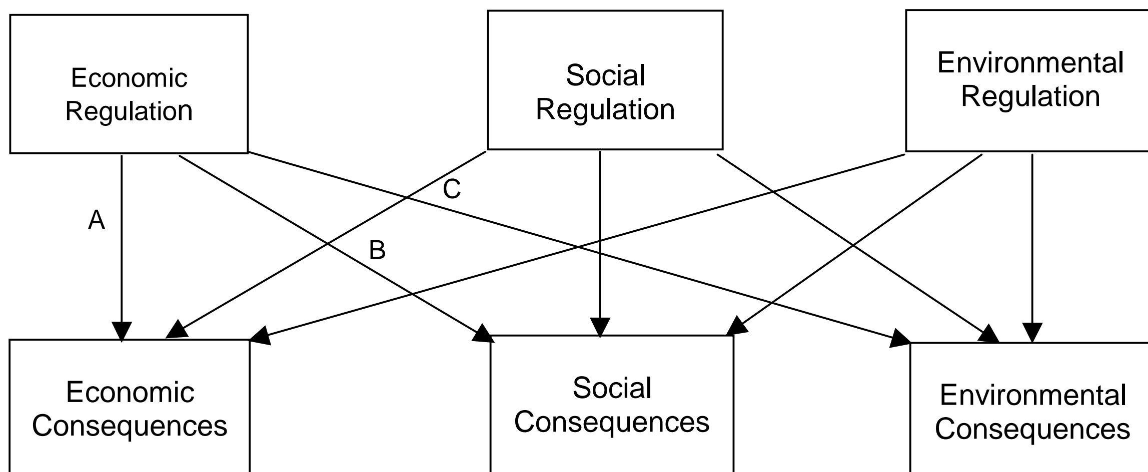
The aim of regulation policy should be to change private sector behaviour in ways that are more consistent with these development goals. This implies a much wider range of objectives for regulation policy, beyond that of promoting the efficient working of markets. The UK Government's *Principles of Good Regulation* (Cabinet Office, 2000b), for example, identifying the following objectives for regulation policy:

- to protect and enhance the rights and liberty of citizens;
- to promote a safe and peaceful society;
- to collect taxes and ensure that they are spent in accordance with policy objectives;
- to safeguard health and safety or protect citizens from 'learning' themselves;
- to protect consumers, employers and vulnerable groups from abuse;
- to promote the efficient working of markets;
- to protect the environment.

Economic regulation will be focused on correcting market failures, and strengthening the enabling business environment. But economic regulation can also have consequences for poverty reduction and environmental protection which need to be considered in the selection of economic regulation instruments (Figure 1: A, B, C). Similarly, environmental and social regulation may have consequences for the other components of the sustainable development goal. It is important that sufficient recognition is given to these linkages when selecting a particular regulation instrument or when a reform in the existing regulatory framework is

being considered. Taking these linkages into consideration is fully consistent with DFID policy to "better integrate environmental sustainability into poverty reduction strategies" (White Paper, 2000: 83). However, to achieve this satisfactorily for the regulatory process as a whole is a considerable challenge.

Figure 1 Linkages between Economic, Social and Environmental Regulation



It *may* be that the positive consequences of an economic regulatory measure are complemented by environmental and social gains – a 'win-win-win' outcome. The thrust of much of the current debate in the development policy of economic interventions, is to argue that economic gains will also have favourable social consequences ("Growth is Good for the Poor – Dollar and Kraay, 2000). Also, market reform and private sector development can, in certain circumstances, work to the long-term benefit of the environment, where, for example, improved environmental practices improves competitiveness or privatisation of public enterprises leads to improvements in environmental performance and responsibility (Kirkpatrick and Lee, 1998). But the more likely outcome is where trade-offs are encountered, with gains in one sphere giving rise to losses in another.

There can be no general presumption that an economic regulatory change will improve market efficiency. The impact will depend upon the balance of economic costs and balances associated with a particular regulation proposal or measure, which will need to be determined on a case by case basis. Furthermore, even where an economic regulatory change can be shown to improve market efficiency and economic growth, there is no guarantee that this will advance the broader goal of sustainable development.

There is a compelling case, therefore, for the systematic appraisal of the potential impacts – economic, social, environmental; positive and negative – of any proposed changes in the existing regulatory framework or new regulatory measures.

4. REGULATORY IMPACT ASSESSMENT (RIA)

Introduction

Strengthening the empirical basis for public policy decisions is increasingly recognised as an essential condition for improving the quality of public management and policymaking. Regulatory impact assessment is a method for analysing the costs and benefits of regulatory change, and includes both regulatory appraisal and regulatory evaluation. Regulatory appraisal is used to describe the ex ante assessment of proposed new or revised regulations, whereas regulatory evaluation refers to the ex post assessment of existing regulations.

Regulatory impact assessment in public decision-making assists in identifying the benefits and the costs of regulation, and contributes to wider objectives of effective and transparent government. Regulatory impact assessment has been widely applied in OECD countries, but there is little evidence of its use in developing countries or in organisations with responsibility for the design of development policy. In part, this may reflect the methodological and operational difficulties that arise in applying RIA.

This section will first explain in more detail what regulatory impact assessment is, and what its objectives are. It will then discuss how RIA might be used as a tool for assessing regulatory change in developing countries, concentrating particularly on economic regulation impact assessment.

What is Regulatory Impact Assessment (RIA)?

Regulatory impact assessment is a technique for improving the empirical basis for regulatory decisions. It does this by systematically and consistently examining potential impacts arising from government action and communicating this information to decision makers. The potential impacts are identified as being positive (benefits) and negative (costs), and the information is conveyed to decision-makers in a way that allows them to consider the full range of benefits and costs that will be associated with the proposed regulatory change.

Box 1 Definitions of RIA

"An RIA is a policy tool which assesses the impact in terms of costs, benefits and risks of any proposed regulation which could affect businesses, charities or the voluntary sector". Cabinet Office, *Good Policy Making: A Guide to Regulatory Impact Assessment*.

"A regulatory impact assessment is an analysis of the estimated cost and the perceived benefits of a proposed regulation. The purpose of preparing the regulatory impact assessment is to help you determine the risks, costs and benefits of your regulatory proposal, and identify who will be affected by the proposed regulation.

A regulatory impact assessment is intended to ensure that any proposed regulation is:

- necessary
- aimed at the right target
- in proportion to the problem or issue being addressed

The regulatory impact assessment is particularly important whenever you are proposing regulations that impose costs on business".

Source: Ministry of Labour and Human Resource Development, Government of Kenya, *Thinking About Regulation? The Better Regulation Guide*, Nairobi.

RIA is not a technocratic tool that substitutes for or replaces other decision methods in the regulatory process, but it can play an important role in strengthening the quality of debate and understanding in the decision making process. The methods used by policymakers to reach decisions on regulation can be classified into five categories (OECD, 1997: 14):

1. *Expert* – the decision is made by a trusted expert, perhaps an appointed regulator, who uses professional judgement to decide what should be done.

2. *Consensus* – the decision is reached by a group of stakeholders who reach a common position that balances their interest.

3. *Political* – the decision is reached by political representatives based on partisan issues of importance to the political process.

4. *Benchmarking* – the decision is based on reliance on an outside model, such as international regulation.

5. *Empirical* – the decision is based on fact-finding and analysis that defines the parameters of action according to established criteria.

RIA is part of the empirical approach to decision-making, and while it is not sufficient for designing sensible public regulatory policy, it can make an important contribution to improving quality of decision-making.

In particular, RIA meets the following criteria for good policy-making (OECD, 1997: 16-18).

1. *Improve understanding of benefits and costs of government action*
   RIA is an evidence-based approach to decision-making, and often draws on economic empirical evidence in assessing benefits and costs.

2. *Integrate multiple policy objectives*
   RIA can be used as an integrating framework to identify and compare the linkages and impacts between economic, social and environmental regulatory changes.

3. *Improve transparency and consultation*
   RIA is closely linked to processes of public consultation, which enhances the transparency of the RIA process, provides quality control for impact analysis, and improves the information provided to decision-makers.

4. *Improve government accountability*
   RIA can improve the involvement and accountability of decision-makers by reporting on

the information used in decision-making and demonstrating how the decision impacts on society.

The application of RIA needs to be appropriate to the expertise, resources and information base available to the analyst. It also needs to be based on sound professional judgement, which matches the resources to be put into RIA against the potential net benefit cost of the regulatory change (in other words, it will often be appropriate to carry out a rapid cost-benefit analysis of applying RIA at different levels of detail, costs and complexity).

The RIA needs to consider the benefits and costs of the regulatory proposal. Most studies concentrate on the costs of regulation assuming that the decision to regulate or deregulate has already been taken. In the former case, the benefits of regulation have been assumed to exceed the costs, and the decision-making reduces to selecting the least-cost alternative method of regulation. In the latter case, it is assumed that regulation imposes a heavy burden on the economy and the decision-making is reduced to identifying the deregulation measure that will produce the largest gain in reducing the costs of regulation. Both are incomplete, and any RIA requires consideration of both benefits and costs.

Some regulatory proposals are intended to deal with risk. These could be risks to the environment, or to consumers and workers safety and health. Risk assessment is part of RIA, and involves identifying the outcome which leads to harm, and estimating the probability that the harm will occur. If the risk is judged to be significant, it will be necessary to consider that controls or mitigation measured are needed.

The benefits and costs should be presented in quantitative terms, and should convey information to the decision-maker on the magnitude, timing and likelihood of the positive and negative impacts. It will often be possible to express the benefits and costs in monetised form, using economic valuation. This has the major advantage of allowing different types of benefits and costs to be aggregated to give a total economic benefit and cost estimate. However, valuing all the effects of regulation in economic terms is often difficult, if not impossible, and even where economic valuation is undertaken, the estimates are of variable quality and reliability. Care needs to be taken, therefore, when estimates of monetised and physical effects are included in the same analysis (as is often the case), in the way in which

these different types of information are weighted and allowed for in the decision-making process.

While these general principles for RIA are straightforward and generally accepted, the methodology for conducting an RIA is much less well developed. The concept is a relatively new one for which there is no established methodology and limited practical experience, particularly relating to developing countries.

What is very familiar is the methodology and application of separate forms of economic, social and environmental appraisal at the project level. Cost benefit analysis, environmental impact assessment and social impact assessment are longstanding, and in the first two cases at least, their methodologies are well established (Lee and Kirkpatrick, 1997).

There is also a small but growing literature on the application of specialised economic, environmental and social appraisals at the macro-policy (strategic) level. This is probably most developed in the economic sector, less developed but growing, in the environmental sector, and least developed in the social sector.

Finally, there is a new approach which is developing a methodology for 'integrated' or 'sustainability' impact assessment, which has been applied at the strategic or policy level, particularly to issues of international trade policy (Kirkpatrick and Lee, 2001; Bond et al., 2001).

Both the UK and US government guides to carrying out RIA, focus mainly on assessing the economic benefits and costs of regulation, although this is less so in the UK case (Cabinet Office, 2000b; White House, 1996). Neither addresses satisfactorily the issue of integrating different types of impacts in an overall assessment of the impact on sustainable development.

The first research task, therefore, is to develop a methodology for undertaking RIA in the context of developing countries.

5. FINANCIAL REGULATION POLICY IN DEVELOPING COUNTRIES

Financial market imperfections contribute to low growth and to poverty in developing countries. By preventing the poor from acquiring productive assets through credit and insurance services, the failures in financial markets restrict economic output and incomes from realising their potential levels. What policies are needed to remove these imperfections in financial markets?

The idea of reducing poverty and improving economic growth through the removal of financial market imperfections is an old idea with a chequered history. Subsidised and directed credit provision was a centrepiece of many developing countries' development strategies in the past, but these experiences were generally judged to have failed, both financially and in terms of their intended poverty alleviation impact.

Subsequent financial liberalisation measures were intended to lead to financial deepening and improved access to credit for previously excluded borrowers and savers. But ex post assessment of financial liberalisation efforts suggests that the expected improvements in the supply and access to credit have not improved. In many countries the over-rapid liberalisation of financial markets has led to increased instability in the financial sector.

Financial liberalisation has also failed to eliminate the fragmentation between the formal and informal financial markets in developing economies. On the contrary, liberalisation may have widened the gap, as banks have withdrawn from commercially unprofitable activities and clients in poorer areas and sectors. In this context, micro-finance has been promoted as a means of directly linking finance and poverty reduction. The belief that micro-finance institutions can both alleviate poverty and be financially sustainable has been translated into 'best practice' technologies which have been widely disseminated by the support of the Consultative Group to Assist the Poorest (CGAP) and other key donors. These initiatives have concentrated, however, on the technology of improving access to credit rather than on measuring the impact on poverty, and as Mosley and Hulme (1998: 784) note, "the assumption that improved access to credit will reduce poverty has seldom been tested, with the fact that small loans being made are taken that the poor are being reached and the fact that loans are being repaid as proof that incomes have increased". Furthermore, where micro-finance institutions are successful in helping the poor, these savings and credit services can

only reach a small proportion of the poor. Providing effective micro-finance services to poor people is part of a poverty reduction strategy – but only a part.

The failure of past policy interventions towards financial markets to improve economic growth and contribute to poverty does not negate the case for public policy directed at the correction of financial market failures and imperfections. Rather, it points to the need for a new approach to policy – "better regulation does not always mean less regulation" (World Bank, 2001: 71).

Recent research on the factors which enhance financial intermediation and financial sector stability and growth has highlighted the key role of effective financial regulation and supervision policy. Case study and cross-country analysis have both confirmed that the strength of the prudential regulation policy environment has had a significant impact on the stability and performance of the former financial sector (Brownbridge and Kirkpatrick, 2000; Williamson and Mahar, 1998; Lingren, Garcia and Saul, 1996; Rossi, 1999, Barth, Caprio and Levine, 2000; Demirguc-Kunt and Detragiache, 1998).

In developing countries, the banks constitute almost the entire financial sector. A strong banking system is therefore the sine qua non for a robust financial sector. LDCs began to implement major reforms to their prudential systems in the 1980s and early 1990s. These reforms were in many cases stimulated by the financial crises which had occurred in the 1980s and/or were part of broader programmes of financial sector reforms funded by loans from the World Bank or other multilateral agencies. Conditionalities related to bank regulation and supervision featured prominently in World Bank financial sector adjustment loans, with a higher probability of inclusion than interest rate deregulation, bank privatisation of directed credit reforms (Cull, 1997).

Prudential reforms followed a broadly similar pattern, although the details and scope of the reforms varied between countries. An industrial country (in particular the US) model of regulation and supervision has been adopted by most LDCs. In referring to the regulatory model as US inspired, we are taking account of specific features of the US model, notably the formal regulations and regular on-site bank examinations conducted by the regulators. The Basle Committee's Core Principles for Effective Banking Supervision, drawn up in 1997, sets out the basic framework of this model (IMF, 1998A). The model involves a set of detailed

prudential regulations, set out in the banking law (e.g. minimum requirements for capital to risk assets, restrictions on banks' asset portfolios including restrictions on large loan exposures and insider lending, auditing requirements etc.), with supervision undertaken directly by a public agency. Supervision entails on-site inspections and off-site monitoring of banks based around the CAMEL principles, in which supervisors evaluate a bank according to its capital asset quality, management, earnings and liquidity (Sheng, 1996B). Supervisors aim to inspect banks at regular intervals and banks are required to submit regular financial reports to the supervisors. Some, but not all, LDCs have also adopted some type of deposit insurance (Kyei, 1995). Prudential reforms have also included considerable institutional strengthening, albeit from very low levels of institutional capacity in many cases. Staffing levels have been expanded, training provided for supervisors, and technical advisors provided to supervisory authorities.

Weaknesses in Prudential Systems

Many LDCs suffered banking crises during the mid to late 1990s, often several years after they had begun to implement prudential reforms. There have been three main sources of weakness in the reformed LDC prudential systems. First, some banking legislations still omit important prudential restrictions, or include provisions which are not strict or precise enough. Second, some regulatory authorities lack the requisite personnel to carry out effective supervision. Third, supervisors have been unable, or unwilling, to rigorously enforce the prudential regulations (Brownbridge and Kirkpatrick, 2000).

The weaknesses in the regulatory processes that were revealed by recent banking crises, particularly in East Asia, have raised doubts over whether a regulatory model designed for advanced economies is optional for LDCs (Caprio, 1997).

A range of proposals and approaches have been made for making prudential regulation more effective in developing countries (Caprio and Honohan, 1999; Honohan and Stiglitz, 1999; Murshed and Subagjo, 2000; Brownbridge and Kirkpatrick, 2000).

The continuing fragmentation of financial markets in developing countries is reflected in the growth of the microfinance sector, as a provider of formal banking services to poor people. As microfinance institutions has expanded, they have become to evolve from lending only institutions into providing deposit services. This has in turn focused attention on the

regulatory environment within which the microfinance institutions operate. There is an increasing interest in the design of regulatory framework that would be conducive to the growth of the microfinance industry to the extent that "microfinance today seems to find itself in the midst of a rush to regulate" (CGAP, 2000).

As with the formal banking sector, there has been a range of proposals and alternative approaches to the issue of regulation of microfinance (Christen and Rosenberg, 2000; Maimbo 2000; Small Enterprise Development, 2000; CGAP, 2000).

It is proposed, therefore, that the second part of this research project will involve the development and application of a regulatory impact assessment (RIA) methodology to the issue of financial sector regulation policy in developing countries.

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