



A Government's Role in Regulation in the 21st- Century Economy*

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INTRODUCTION

The rapidly changing economic environment resulting from a decade-long economic boom in the Southeast Asian region has left the public sector trailing behind the private sector. With the expansion of the scale and scope of economic activities, the government's human and financial resources are becoming increasingly overstretched. It is thus time for the government to ponder and to define its future role in the economy.

Why Regulate?

Why does a government get involved in certain types of economic activities and not others? There are both economic and non-economic rationales for the government's presence in certain industries. The economic rationale for regulation is that the market exhibits a type of market failure such that left on its own, it (the market) will not produce an efficient outcome. There are several reasons why this may be the case. The first is that the market exhibits a natural monopoly—i.e., a single producer or provider will supply the good or service for the entire market. Natural monopoly normally arises from the fact that the production of a particular good or service requires large initial fixed investment costs and relatively small variable costs. The combination of large fixed costs and small variable costs results in returns to scale, meaning that the greater the volume of production, the lower the per unit cost will be. The logic is simple. Since fixed costs do not vary with the volume produced, the greater the scale of production, the more fixed costs are spread out, resulting in a lower cost for each unit produced.

If the monopolist is the lowest-cost provider, then why is a monopolistic equilibrium inefficient? The problem is that in the absence of competition, a monopolist tends to abuse its market power by charging consumers prices that far exceed costs. That is where the government must come in to control the amount of profits that the monopolist may extract from consumers.

The other type of market failure is associated with externalities. Certain types of economic activity exhibit external effects that can be either negative or positive. Take smoking for an example. If you smoke in a public place you unwittingly (or not) impose external costs on others around you—i.e., the costs of inhaling the smoke from your cigarette. This is a negative external effect. Pollution is another prime example of a negative external effect on a larger scale. Whenever you use your car, you create pollution which degrades the quality of the air in the surrounding area. There are other economic activities that may generate positive economic and social spillovers such as transportation and telecommunications. The problem with externalities is that in a free market the producers of the external effects (the smoker or the driver) are not made accountable for his actions. Hence, the government must step in to protect the interest of the public as a whole.

Finally, there are social obligations that the government must tend to. Services such as electricity, water, telephone and basic transportation are considered public services to which all citizens are entitled. Social service obligations are closely associated with the concept of "universal service" or "universal access." Since the provision of these services are based on a purely social goal, rather than a commercial goal, it is incompatible with the free market. In this case, the government will have to intervene to ensure that such services are provided in a manner that is consistent with the goal of service universality.

So, there are many reasons why the government has to step in where markets fail to produce the desirable outcome. Yet, we have witnessed waves of deregulation and liberalization of many of the services that the governments once controlled. Why is that so? What has prompted this recent phenomena that is occurring in every corner of the world?

Why Deregulate?

There are two reasons why there has been a clear trend toward decreasing the government's role in economic activities. First, past experiences seem to indicate that "regulatory failures" exist which can produce adverse results.

Regulatory failure may occur for various reasons. The first is associated with the "capture theory." The theory posits that because the regulated company is likely to have superior information, as it is involved in the regulated economic activity, it can easily manipulate the regulator to its own advantage. Consequently, the regulator ends up protecting the producer rather than the consumer. The second reason for a regulatory failure arises from the fact that the regulator itself is not perfect. We must not forget that by creating a regulator, we entrust an enormous amount of responsibility and power unto a single body. This resembles an autocratic government. We all hope for a benevolent and efficient regulator, but there are both up-side and down-side risks involved when power is concentrated in a single entity.

What are the essential characteristics of an ideal regulator? There are a few key words that may describe the desirable characteristics of the regulatory agency: efficiency, impartiality, autonomy, transparency and accountability. Efficiency requires a clear objective and mandate, a competent staff and a clear set of regulatory rules. The objective of a regulatory agency should be to promote national economic welfare (rather than protect the indigenous industry) and its mandate would be to oversee competition and universal access to the extent that they meet the specified objective. Impartiality requires that there would be no representation of special interests on the board. Commissioners should not have either direct or indirect vested interest in the industry they regulate or hold a political position. For the regulator to be able to perform its task effectively, a certain degree of autonomy from the government is also required. An independent source of financing for the regulatory agency, either from a guaranteed line in the national budget, from licensing fees, or from excise taxes can promote autonomy and impartiality.

The balance between autonomy and accountability is delicate one. On the one hand, the regulatory agency requires some room to maneuver to be able to perform its task efficiently. On the other hand, the agency is also accountable to the government which, in turn, is accountable to its constituency. Hence, too much independence may imply a democratic deficit. For instance, in the case of the telecommunications industry, accountability in the regulatory bodies, such as the Federal Communications Commission in the United States, the Canadian Radio-Television and Telecommunications Commission in Canada, and the Office of Telecommunications in the United Kingdom, has been assured through various means, including the government's power in appointing the commissioners, its control over telecommunications plans, which the regulator is obligated to execute, or, as in the case of England, its power to grant operating licenses. Accountability not only upholds democracy, but also facilitates a system of checks-and-balances within the regulatory system. The answer with regard to how much autonomy the regulatory agency should have is a very complicated if not philosophical one. But if a regulatory body has any similarity to a central bank, the present trend indicates a movement toward greater independence.

Autonomy may also imply an element of discretion. How much discretionary power should a regulatory body have? The answer to this question is likely to be "a lot" for the case of Thailand and most other developing countries where regulatory procedures have been ad hoc and not clearly defined. For example, an antitrust agency or a consumer-protection board does not yet exist in Thailand. The regulator will then have to assume the enormous task of establishing its own set of anti-competitive and consumer-protection rules and handling procedures. The absence of a general set of laws or rules that can be referred to makes the task of regulation significantly more complicated and at the same time prone to arbitrariness and inconsistency. But there are ways to limit the damage associated with discretion. In the situation where the regulatory boards hold a great deal of discretionary importance, public hearings, appeals provisions and notification and publication requirements on issues and decisions that are considered to be of importance may increase transparency. The task of regulation is a complex one which requires a considerable amount of documentation, argumentation and analysis. Transparency can promote all of the above desirable qualities of a regulatory agency mentioned above, which are efficiency, impartiality, autonomy, transparency and accountability. Thus, a lot of effort should be spent on ensuring that the instituted regulatory agency has a transparent working procedure.

Besides regulatory failure arising from limitations with respect to the capability and the effectiveness of the regulator itself, there are also many adverse effects associated with the maintenance of a regulated monopoly. First, there is no doubt a large amount of rent to be had in a monopolistic market. Such large rents will no doubt instigate unproductive rent-seeking behavior that may involve anything from legitimate lobbying to downright corruption. Such activities can easily rock the integrity of a regulatory body in its pursuit of the social goal of ensuring that those rents go to the consumers (in terms of lower prices) instead of the producers.

The second reason for the recent trend toward deregulation and privatization is that the costs associated with the maintenance of a monopoly is manifold and larger than what economic theories might suggest. First, there are

monopoly costs that arise from inefficiencies. In the absence of competition, the producer has no incentive to cut costs and improve the quality and variety of its goods or services. In industries prescribed by rapid technological advancement, the lack of market innovation is likely to represent a significant opportunity-loss to the society. This argument questions the validity of the traditional economic justification for regulation and the maintenance of a monopoly which is based on a "static" rather than a "dynamic" analysis.

The policy shift toward less government intervention in economic activities also stems in part from fundamental structural changes in the regulated markets. Technological advancement in many areas have led to cost reductions and market expansions which facilitate greater competition. Take the telecommunications industry as an example. The introduction of alternative media of communications, ranging from microwaves, electromagnetic waves (i.e., satellite links, cellular-phone communications and pager services) to optical fibers gave rise to countless market opportunities and hence, provide room for competition.

Steps to Deregulate

In developing countries where the government still assumes the role of the sole provider in many services, the path to deregulation is both long and treacherous. The first and probably most important task is to revise the existing sets of laws and regulations governing the regulated activities. Many laws in developing countries are ancient and constructed in an ad hoc manner. A new set of laws and a revision of the existing ones, in keeping with the present economic and social environment, and the general policy trends will be rudimentary to the process of liberalizing a market. In developing countries, out-of-date laws are often the major impediment to industrial development. For example, in Thailand's telecommunications industry, the delay in the revision of the 1934 laws which granted statutory monopolies in the ownership of infrastructure-networks to two public enterprises resulted in the granting of private concessions in a rather odd form of BTO (build-transfer-operate), which is unique only to the country. These concessions are inefficient and prove a serious obstacle to market liberalization (for further elaboration on this point please see the study entitled Telecommunications Policy: Preparing for Market Liberalization (Deunden 1996)).

The main content of the legal reform should include the abolition of the statutory monopoly and the establishment of a regulatory body. Once the legal framework required to support competition and a regulator is in place, the next step would be to privatize the state enterprises in the market. Because there is an unwritten rule that the government will always support a public enterprise, through granting special privileges or direct subsidies, there can be no fair competition where a government operator prevails. Finally, when the market is open to competition from the private sector, another important policy issue that the government will have to face is the issue of liberalization of the market which spells foreign competition.

Should foreign operators be allowed into the domestic market unconditionally? Or should there be certain restrictions on foreign shares of telecommunications businesses? We must first ask ourselves what the rationales behind foreign ownership restrictions are? There are two arguments to why a country may choose to limit foreign ownership in a domestic telecommunications market. First, if telecommunications is considered to be a service that is crucial to national security and integrity, then foreign ownership should be limited. The second argument echoes that of an "infant-industry" argument. That is, the country has a clear competitive disadvantage in telecommunications services. If experienced operators from overseas are allowed in without any barriers, the industry will surely fall into foreign hands and indigenous operators will not have a remote chance in establishing a foothold in the market. To promote the growth of indigenous industry, foreign ownership is often limited to a minority share. The cost of protection would be inefficiency, which will most likely be born by consumers in terms of higher service prices and inferior service standards. The problem with such a policy is that—without proper incentives—protection will foster neither increased efficiency nor improvement in competitiveness as it was intended to produce. If so, the domestic industry will never mature and hence, protective measures can never be lifted. Under such a scenario, the intended benefits from protection would never be realized, while the cost would be enormous. Thus, the protection period must be limited in order to force the local industries to develop the required competitiveness.

How to regulate?

How does a government regulate? There is a whole literature on the theory of regulations that can be found in most industrial organization texts, which will not be discussed here. However, the general trend (which can be found in countries with long-standing experience in regulations such as the United States and England) is that regulators are relying more and more on market-based devices to correct various types of market failure rather than the traditional "command-and-control" method, where a government dictates the rules by which one must abide. For example, to reduce pollution, the government would choose to impose a gasoline tax rather than increase emission standards. Or,

as another example, to ration the usage of electromagnetic frequencies (which is becoming a scarce resource with modern telecommunications technology), the regulator is auctioning the frequencies. The advantage of a market-based device over a command-and-control device is that it does not require monitoring and it leaves little room for discretion and is less arbitrary and therefore less corrupt.

Another salient feature of regulation in many developed economies is that the regulator relies on a general (nation-wide) set of laws—i.e., the anti-competition laws and consumers' protection law—rather than industry-specific laws. This minimizes inconsistencies, arbitrariness and discretion in regulation among different industries.

Who gains from deregulation?

The most important question is who will gain from deregulation for if deregulation leaves a party worse off, it may be subject to resistance and may not even be optimal after all. The answer is that all parties will gain: the government, the consumers and the producers.

First, how does a government gain from privatization and liberalization? In privatizing money-losing public enterprises, the government can cut its annual expenditures and at the same time generate revenues from the sales. The government may be more reluctant to privatize money-making public enterprises which contribute annually to the treasury. The government should realize that the abolition of the monopolistic status of the state-owned enterprises does not necessarily imply a loss of government revenues. Privatization simply means that the former public enterprises will contribute to the government's coffer through corporate taxation rather than in the form of transfers within the government. Since the tax rate is universal across industries, generation of revenues through taxation is clearly less distortionary than through public enterprise transfers. More importantly, liberalization will stimulate competition, innovation, and development, resulting in greater efficiency and service diversity. The expansion of the range of services that are available will bring in additional revenues to the government.

Employment is probably the other major concern of the government when it comes to liberalization. The displacement of workers could be minimized or even avoided if these enterprises are as efficient and competitive as their competitors. To improve efficiency, corporatization and privatization of state enterprises are a prerequisite. Without putting the enterprises through these processes, they will surely sink under bureaucratic weight.

Consumers will obviously gain from competition through lower prices, improved service quality and greater service variety. Finally, producers will gain from greater market opportunities spawned by competition.

CONCLUSION—A GOVERNMENT'S ROLE IN THE 21ST-CENTURY

In a nutshell, how can one describe a government's role in the industrial sector in the next century? The government would take on a profile as a regulator rather than an operator. The role of the government will be concentrated only on regulating three types of markets: one where monopoly prevails; one which exhibit externalities; and one which involves the provision of public services. The private sector will assume the role of the operator in all markets. A new-wave regulator will be one that has a well-defined mandate to serve the interest of the public (the consumers), has a clearly specified set of regulatory rules, such that its decisions can be monitored and challenged if need be, and is sufficiently independent of but at the same time, accountable to the government.

REFERENCE

Deunden Nikomborirak. 1996. Telecommunications Policy: Preparing for Market Liberalization. Paper presented at the Public Economics Workshop held jointly by the Canadian International Development Agency (CIDA) and the Malaysian Institute of Economic Research (MIER), Kuala Lumpur, Malaysia, June 25-26, 1996.