Chapter II

Regulation, De-regulation and Regulation in the De-regulated Environment:

Conceptual Framework
The aim of this Chapter is to explain the concepts of regulation, de-regulation and the process of regulation in the de-regulated environment. The chapter has been divided into three sections. Section I deals with regulation, its meaning, types and critique along with the theory of government failure. The Section II touches upon the intermediate stage of deregulation. The last Section III comprehensively covers the concept of regulation in the de-regulated environment including its rationale, functions, factors affecting it, challenges faced by it and concluding observations.

I

Regulation

Mostly government intervention can occur through four available economic instruments: (i) provision, where the government provides goods or services through the government budget; (ii) subsidy, which is really a sub-category of provision and where the government assists someone in the private economy to provide government-desired goods or services; (iii) production, where government produces goods and services for sale in the market, and (iv) regulation, which involves using the coercive powers of the state to allow or prohibit certain activities in the private sector. The use of these has varied over time and according to the particular government function.1

Out of these government interventions, there has been a shift away from government provision with budget cut-backs and contracting-out; less subsidies being given and shift away from public production of goods and services through privatization. However, on the other hand, there has been an increase in public regulation.2 Thus, regulation as an important instrument of government intervention needs to be studied in detail.

2.1 REGULATION

According to Rosenbloom, “In recent years, regulation has emerged as an area of distinctive concern in public administration. ..... It represents a very

2 Ibid., p. 90.
direct use of governmental power to penetrate spheres of life that were once left primarily to the workings of private social and economic forces”.3

Regulation means using laws made by government to affect the private economy in some way. Regulation is also seen as a set of incentives based on mandated actions and the explicit threat of punishment for non-compliance. Regulation essentially involves allowing or prohibiting activities in the economy through the legal system, e.g. setting tariffs, granting licenses or permits and regulating the labour market.4

Regulation mandated by the government or state attempts to produce outcomes which might not otherwise occur, produce or prevent outcomes in different places to what might otherwise occur, or produce or prevent outcomes in different timescales than would otherwise occur. Regulations rarely produce complete outcomes or prevent outcomes completely but they generally do modify what would otherwise take place. Common examples of regulation include attempts to control market entries, prices, wages, pollution effects, employment for certain people in certain industries, standards of production for certain goods and services.5

According to Shafritz and Russell, “Public Administration is Regulation – It is government telling citizens and businesses what they may and may not do. Regulation is one of the oldest functions of the government .... Modern day regulation is so pervasive and so commonplace that we see it every day and accept it without thinking ...... Our lives are constantly governed, or interfered with, by regulation”.6

Select Definitions

“In the context of government and public services regulation (as a process) is the control of something by rules, as opposed to its prohibition. In

3 Rosenbloom, op. cit., p. 354.
4 Ibid., pp. 88-89.
economics, it is part of the government relationship with markets, often seen as the opposite of deregulation”.7

“Regulation is the totality of government controls on the social and economic activities of its citizens; the rule-making process of those administrative agencies charged with the official interpretation of laws”.8

“Regulation is also defined as the rules enforced by a government agency to restrict or control economic activity in price setting, product standards, trading standards and the conditions under which firms can enter an industry”.9

“Government rules imposed on the pricing, quality, distribution, or other characteristics of products and services”.10

“The government function of controlling or directing economic entities through the process of rulemaking and adjudication”.11

“A regulation is a legal restriction promulgated by government administrative agencies through rulemaking supported by a threat of sanction or a fine. This administrative law or regulatory law is in contrast to statutory or case law”.12

2.2 TYPES OF REGULATION

Regulation can be divided into two main categories – macro and micro. Macro regulation is concerned with attempts to manipulate the general level of economic activity – i.e. income, employment and prices – through the agency of monetary, budgetary and prices and income policies. Micro regulation can be further subdivided into self-regulation and external regulation.13

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9 www.econ100.com/eu5e/open/glossary.html of ECON 100
11 www.pplweb.com/glossary.htm of PPL Corporation
In case of external regulation government departments or special bodies created by the state, both of which are external to the industry or enterprise, impose controls. This externally imposed regulation can be divided into three categories – anti trust, economic and social (See Figure 2.1).

**Figure 2.1**

Diagrammatical Representation of Types of Regulation

- **Anti trust** – It is a form of regulation as it seeks to force businessmen to compete. It is a policy which addresses itself to phenomena such as dominant firms, oligopolies, mergers and restrictive business practices. Antitrust is a form of regulation, which is appropriate, where competition is feasible.

- **Economic** - But, there are some industries where policy makers have tended to conclude that competition was not feasible. This was generally the case, where natural monopoly conditions existed – i.e., where unit costs continued to drop as output increased and where therefore it was most efficient if only one firm served the market. It was generally accepted that – Water, Gas, Electricity and Telecommunications were industries, where elements of natural monopoly existed. However, if the force of competition was suspended, supply being left in the hands of a private monopolist, then it was essential that the consumer be protected against exploitation. This is where regulation came in.
Social Regulation- Industries which are subject to competition and also industries which operate under a system of economic regulation may nevertheless fail in some degree. Such failures may be concerned with externalities (e.g. pollution), the difficulties faced by consumers in respect of information and safety, the possibility of injury or death at the workplace and the problem of discrimination in access to jobs. This gives rise to regulation concerned with environmental protection, consumer protection, occupational health and safety and affirmative action. Unlike economic regulation, such social regulation, or what some economists have called ‘new style’ regulation, often applies across the economy.14

2.3 CRITIQUE OF REGULATION

As the scope of regulatory administration has grown, greater attention has been paid to its economic, political, and social costs and benefits – and many have come to believe that the costs are too high and that regulatory reform or deregulation is often desirable.15 The problems of regulation are that it may be difficult to obtain the information that is necessary to judge the activities of privatized utilities; that regulators may become the prisoners of those they regulate; and that the regulatory regime may serve as a block on technical progress. “Regulation may create the worst of both worlds, neither defending the public interest effectively, nor generating the benefits of the private sector. Regulations adopted to address a specific and fairly well-defined problem create unintended economic distortions. These resulting problems are addressed with further stop-gap regulations. The cycle repeats itself: at each stage there are economic winners and losers as regulation alters prices, costs, contracts, supplies, and demands. Affected parties that are well-organized and well-endowed financially are coalesced and inevitably influence the growing patchwork of regulation. The end result is a system that, in its overall design, accords with no one’s conception of sound economic policy for the country but has well-entrenched special interest residing in each of its component parts”.16

14 Ibid.
15 Rosenbloom, op. cit., p. 354.
Regulation or rather ‘over-regulation’ resulted in drawbacks and received wide criticism. Regulation has serious negative impacts on the productivity, growth, and innovation of the economy. Regulatory commissions have been criticized for developing cozy relationships with those they are charged with regulating. Another criticism of regulatory administration is that there is a tendency to write over inclusive rules and then to expand them even further.

The case against regulatory administration is built on the premises that regulation is costly as it affects costs, productivity, and innovation; hampers economic performance; causes delay; staffed by political appointees of less than impressive qualifications; causes corruption by developing cozy relationships with those they were charged with regulating and favouritism in the enforcement of law and orientation towards the interests of the industry rather than public interest; tendency to write over inclusive rules and then to expand them even further; difficult to manage.¹⁷

This pessimistic phase about the state and development viewed state as a major obstacle to development, acting on behalf of narrow interest groups or on behalf of politicians and bureaucrats (i.e., on its own behalf) rather than for the greater good.¹⁸

2.4 THEORY OF GOVERNMENT FAILURE

As discussed earlier, the theory of market failure postulated that the market is bound to fail in certain set of circumstances and hence there is a need for the Government to intervene. In contrast to the theory of market failure, the theory of government failure is not well articulated. Drawing parallel to the theory of market failure, the theory of government failure argues that the inherent characteristics of demand and supply for government services or over-regulation will lead to inefficiency. It is argued that the demand for public sector output has become more pressing over time. According to Wolf, “there are five reasons for this growth in demand: increased awareness of market shortcomings; political organization and

¹⁷ Rosenbloom, op.cit., pp. 369-76.
¹⁸ Meier & Rauch, op.cit., p. 421
enfranchisement; the structure of political rewards; the high time discount of political actors; and the decoupling of burdens and benefits. Each of these conditions, it is maintained, will tend to lead to the over-supply of publicly produced goods. It is further argued that the supply characteristics of the public sector are distinctive. There is difficulty in defining and measuring output, both in principle and in practice, and there are particular problems in the evaluation of quality. Second, the supply of public sector goods is in the hands of a monopoly which has the backing of law, so that the market is not contestable. Third, the production technology is uncertain, in that the relation between inputs and outputs can not easily be specified. Finally, there is no bottom-line in the public sector and that there is no mechanism for the termination of unsuccessful public policies. These characteristics of the supply and demand for goods and services in the public sector will lead to systematic non-market failures.19

The New Right School of thought comprising Public Choice Theory and Principal-Agent Theory broadly maintain that state involvement leads to increasing monopoly, increasing budget and suppressing of entrepreneurial behaviour, limiting choice, over-production of unwanted services and encouragement to waste and inefficiency. In view of this the New Right has forcefully argued retrieval of the State as a regulator and producer. Therefore, deregulation and privatization are amongst six point reform agenda of the New Right.20

Public choice theorists, such as Buchanan, Niskanen, Tullock and Mueller, etc. argue that state is subject to failure just as is the market. The simplest accusation against the public sector is that it is wasteful in the way that it uses resources because politicians and public officials have no incentive to control costs. They identify three basic sources of failure in government organizations. First, it can not be assumed that politicians will demand the pattern of public sector outputs that reflects the best interests of society as a whole. They will have their own interests to pursue and they will be subject to conflicting demands and pressures from special interests.

Second, the bureaucracy will not necessarily carry out the wishes of the politicians, even if the latter do express the public good, since it is likely not to be in the bureaucrat's interests to do so. Third, it is unlikely that bureaucrats will act efficiently in producing whatever it is decided should be produced, since it may be in their interests to be inefficient.\(^21\)

The literature on Principal-Agent theory also supports deregulation. According to this literature the principal and the agent follow different objectives. In the absence of adequate information with the principal, the agent operating at each level chooses an effort level, which is not efficient and cost effective.\(^22\)

It is opined that State intervention might result in some problems, like, Government may make bigger mistakes than markets; Government planning may be more rigid and inflexible than private decision-making; Government controls may prevent private sector individual initiative if there are many bureaucratic obstacles; Governments may be dominated by narrow interest groups interested in their own welfare and sometimes actively hostile to large sections of the population.\(^23\)

II  
De-Regulation

Jan-Erik Lane opines that "how exactly one measures the degree of regulation in a sector of society is far from clear, but there is a general consensus that modern society is overregulated and is in need of regulatory reform, such as deregulation of markets."\(^24\)

2.5 DE-REGULATION

Theory of government failure, New Rights School of thought, particularly, public choice theory and resultant draw backs of regulatory administration and over-regulation provide solid strength for advancing a case in favour of deregulation. Since regulation is so broad in scope, so varied in

\(^{21}\) Walsh, op.cit., p. 17.  
\(^{22}\) Ghuman, loc.cit., p. 771.  
\(^{23}\) Nicholas Stern quoted in Meier & Rauch, op.cit., p. 431.  
\(^{24}\) Lane, op. cit., p. 119.
kind, so difficult to evaluate, and so problematic to implement, it is not surprising that many have favoured regulatory reform and deregulation in recent years. Other arguments advanced in favour of de-regulation are that free markets can provide more benefits to the society than can regulated ones.\textsuperscript{25}

**De-regulation Defined**

It simply means that an industry/service which has previously been able to protect itself from competition, either because it has been given a statutory monopoly or because it has been successful in erecting barriers to entry, is exposed to competitive forces through the Government in effect changing the rules of the game.\textsuperscript{26}

Deregulation refers to the removal, relaxation or modification of all the three types of external controls (Antitrust, Economic and Social). Strictly interpreted it can be taken to refer to the removal of all regulation. But, that is an improbable development. In practice, when we use the word deregulation, we are employing a term which encompasses (a) differing degrees of deregulation and (b) a variety of possible changes in the way in which regulation operates. All this can best be described as regulatory reform.

### III

#### Regulation in the De-Regulated Environment

2.6 **REGULATION IN THE DE-REGULATED ENVIRONMENT**

De-regulation as stated earlier connotes the withdrawal of the state or reducing the control of the state over the supply of goods and services by the private sector. Interestingly, the deregulation is accompanied by fresh but different form of regulation by the state. This combination of deregulation and regulation is unfolding issues, which have far reaching implications and challenges for public governance. It is in this backdrop that the present study has been initiated.

\textsuperscript{25} Rosenbloom, *op. cit.*, pp. 376-79.
\textsuperscript{26} Curven, *op. cit.*, p.39.
Laxmi Narain notes “the British experience of regulation shows that, if left alone, the utilities cannot be relied upon to treat their customers fairly and to provide the required services in an efficient and economic manner. The privatization would be most efficient if it were preceded by institution building and the establishment of an appropriate regulatory framework. The policy of ‘privatization now and regulation later’ has often failed because early privatization has created strong vested interests to block the later attempts at regulation. Privatization is not an end in itself but a means to achieving efficiency, which is generally associated with free-market competition. Regulation has to be instituted to ensure that the market conditions necessary for efficiency evolve and where they do not, regulatory intervention be made to provide the best possible semblance of marketisation. Therefore an effective regulatory mechanism is required to ensure quality and value for money to the consumer and to provide a level playing field to various operators”.27

It is suggested that the tasks of regulation can be divided into two parts: promoting competition where it is feasible; and preventing the abuse of monopoly power where it is not. The first task involves identification of the economic constraints on competition and the development of the policies to minimize their effect and the second task involves identification of the potential abuses of market power and the formulation of regulatory controls to inhibit these abuses.28

In the past, most developing economies were characterized by significant government intervention, which included involvement marked with dominance of large state-owned enterprises; licensing; permits; quotas; and price controls. This was the pattern followed by most developing countries as their economic management paradigm of a welfare state through command and control measures, believing that the state is the guarantor of freedoms and provider of all needs. Since economic liberalization started during 1980s and 1990s, there have been considerable policy changes, with increased reliance on market forces. Along with policy changes, several developing and

27 Narain, op. cit., pp. 305-308.
transition economies have adopted competition laws as a follow up to their market-oriented economic reforms. Additionally, most of these countries have adopted regulatory laws in several sectors, opened up for private players, which were hitherto reserved for public sector only. This upsurge in interest in competition and regulatory laws in developing economies reflects the substantial changes that have been taking place in their economic governance system.29

2.7 RATIONALE FOR RE-REGULATION

Entry of private sector into core areas of infrastructure like power, telecommunications, insurance, education and health has necessitated that appropriate regulatory framework is put in place to avoid unhealthy competition and to ensure reasonable price and quality of services and products to the consumers.

Requirement for regulation is mainly to bring about risk allocation between the service providers and other entities. The regulator constantly interacts, influences and is influenced by all the components in the reform process and is expected to control and correct the process after balancing all conflicting interests. The range of business activities covered by economic regulators is vast, directly affecting the vital interests of all citizens. With diminishing role of Government and emergence of private sector in new areas, regulatory framework assumes importance.30

The thrust of economic reforms has been to allow for greater competition. The underlying rationale is that competitive markets ensure efficiency resulting in best possible choice of quality, lowest prices and adequate supplies to the consumers. In cases where competitive markets do not exist or yield desired results, some form of intervention to control price, quality of products and services in the market is required, and thus regulation

is needed. These reasons collectively stress on the need for putting in place effective regulatory institutions to administer a set of transparent, consistent and non-discriminatory rules that create a competitive, dynamic environment in which firms can thrive, consumer interests are protected, and orderly growth of sector is facilitated. \(^{31}\)

A reassessment of the performance of the infrastructure sectors in many countries led to the belief that market forces and competition can improve the production and delivery of services without affecting the economies of scale. However, despite possibilities of such competition, the market structure in infrastructure services retains a monopolistic element in most countries. Governments, therefore, have to continue to protect consumer interests by acting as substitute for a marketplace. At the same time, they have to provide a level playing field and conditions for fair returns to new investors. Further, the privatization process can lead to high transaction costs. These have to be mitigated. Governments are also less equipped to respond to the complex and dynamic environment changes in infrastructure sectors as they do not have the requisite expertise. It also becomes necessary to develop a framework for private and public partnership enabling efficient delivery of infrastructure services.

According to Sundar and Sarkar, “With governments in many countries continuing to be stakeholders, it was natural that there should be an independent and outside regulator, remaining equidistant from all service providers and stakeholders, including the government. These considerations provide a sound rationale for a new type of regulation and governance in many countries. Several benefits are likely to accrue out of a ‘rational and evenhanded’ regulation, which include building consumer trust and confidence; establishing better avenues for communication between the regulated utility and stakeholders (most often, it is the regulatory agency that fosters such dialogue through technical conferences, symposia, open

hearings, etc.); ensuring a fair return on the utility and just and reasonable rates for the consumer; encouraging better standards for delivery of services; and letting the utility and other stakeholders assist in developing them.” \(^{32}\)

### 2.8 FUNCTIONS OF REGULATION

Regulation in the de-regulated environment plays a significant role and essentially performs the following major functions (See Figure 2.2):

(i) **Balancing Competing Interests**

The deregulated environment opens up hitherto closed and restricted sectors and thereby allows competition and existence of private players. In such an environment, the interests of various stakeholders are involved. These include government, service providers, consumers and consumer groups. At times these interests compete and are in conflict with each other. The regulation performs the essential function of balancing the interests of these various stakeholders.

(ii) **Controlling Prices**

From the philosophy of *laissez faire* to regulation to de-regulation, the role of State has been evolving over the years. The intervention by the State directly or indirectly is necessitated because of the need to control prices among others. The independent regulator is best suited to perform this essential task in a de-regulated environment. The regulation ensures that prices are neither jacked up by the service providers nor are they too low, which may discourage the incentive for the growth of any sector.

(iii) **Protection of Consumer Interest**

Amongst the various stakeholders in any sector, the interests of consumers are paramount. All other stakeholders exist for them and

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without them, they hold no value. The regulation performs the vital function of protecting the interests of consumers. The protection of consumer interest is undertaken by the regulator in the form of keeping a check on the prices of services; making consumers aware about their rights and entitlements; laying down and monitoring quality of services, etc.

(iv) Promoting Competition

Less restrictions and permission for various service providers to operate help in the promotion of competition in any sector. Impartial and intelligent regulation with suitable and timely interventions by the regulator creates favorable environment for inviting investments and promoting competition.

(v) Expanding the Sector

The de-regulated environment provides scope for the growth of a sector. Monopolistic tendencies of the State gives way to competitive environment and this provides scope for expanding the sector with more investments and expansion of the sector to hitherto un-ventured areas along with introduction of attractive services and packages. However, all this is ensured and made possible only because of the role of regulation, in the absence of which these advantages are more likely to fritter away.

(vi) Ensuring Quality of Service

The provision of service is important, yet mere provision is not enough. The need is to provide good quality service delivery also. Regulation in a de-regulated environment lays down quality of service parameters for a given sector and monitors the performance of service providers in terms of adherence or non-adherence. Issuing consultation papers and regulations and conducting surveys to assess the adherence to benchmarks is an important function of the regulation.
(vii) Ensuring Access to All/Equity

The de-regulated environment provides conditions for the expansion and growth of the sector. This growth, however, can be asymmetrical and locale specific. For example most of the deregulated services tends to expand in urban areas and primarily looks after the interests of urban consumers. It is only the regulation, which prevents the accumulation of services in only one location and helps to cater to the needs of the consumers living in the rural areas also. Left to themselves, industries tends to be profit oriented and neglects the
goals of equity and access. Thus, ensuring equity and access of services to all is an important endeavour of the regulation.

(viii) Spreading Awareness

One of the major functions of a regulatory authority is to spread awareness about the regulatory initiatives undertaken by it; various regulations and orders in the field; and the developments taking place in the concerned sector. These are aimed at ensuring that consumer is aware and his/her rights are protected.

2.9 FACTORS INFLUENCING REGULATION

There are number of factors which influence the Regulation in the de-regulated environment. The prominent among them include (See Figure 2.3):

(i) Political Climate

The political environment is an important factor affecting regulation. Regulatory authorities operate in a political environment and as such they have to take into consideration the political factors before taking any decision. The decisions arrived at by regulatory bodies in an insulated environment may make economic sense and may score high on efficiency, however, the political costs may be too heavy to pay for implementing such decisions. Thus, political climate is an important factor which affects regulatory governance.

(ii) Political Maturity

Regulation especially in a de-regulated environment is a political decision and it hinges upon the level of political maturity. In developing countries, the policy-making is constrained by the lack of resources and innumerable competing and pressing problems. Only a mature political leadership can think and plan for future. The decision to establish regulatory agencies in various sectors is undertaken by taking into consideration the timing, nature of the sector, level of growth of the sector, prospects and equity considerations by a mature political leadership. The level of political maturity has a significant bearing on the regulatory governance. The mature political class
would ensure that only experts and specialists are appointed to the regulatory authorities. Further there would be no or limited interference by them in the day to day functioning of the regulatory authority. The decisions of the regulatory authorities are arrived at by the specialists and that too after due deliberations and as such they ought to be given due respect by the political class.

(iii) Political Will

The introduction of regulatory governance in a sector after opening it up depends upon the political will. The policy of de-licensing and allowing the entry of private players into various areas of infrastructure in the early 1990s was a decision which relied on political will. The decision to establish regulatory commission in a sector to look after the interests of various stakeholders again depends on the will of political class. In developing countries, adoption and implementation of competition and regulatory laws is even more politically charged, as its objective is to constrain concentrated political and economic power while helping the more diffuse interests of ordinary, often poor, consumers and producers. Little is understood of how political processes shape the complex trade-offs between competition and public interest over distributional outcomes in low-income economies. In these cases, weak markets, immature cultures of competition, sizeable informal sectors, information asymmetries, and higher transaction costs cause market distortions, considerable inequalities and weak or non-existent institutional capacities producing much higher risks of ‘state capture’. In countries where there is substantial national commitment towards market reforms, regulatory agencies have been quite successful.33

(iv) Economic Structure:

The structure of the economy and the relative weightages of the component sections determine the need for and level of regulation. The economies with more components of primary and secondary

33 Mehta; Agarwal; and Singh, op. cit., p.14.
sectors have less need for regulatory governance. The growth of tertiary component and the emerging competition instead of monopolies in infrastructure and absence of competition creates need for regulatory mechanism.

Figure 2.3
Major Factors Influencing Regulation

(v) Economic Development
The early stages of economic development of a developing economy are dominated by public sector. The government maintains such a system with lots of curbs and controls. In such a command economy,
the supply and prices are regulated by the government and market forces hardly have any role to play. With the passage of time it results in stifling of the economy owing to various shortcomings. The governments normally go for opening up the sector and bringing in competition, which in turn necessitates the establishment of a regulatory authority in the concerned sector.

(vi) Need for Expanding Infrastructure

One of the factors which necessitate the establishment of regulation in a sector is the need for expanding infrastructure. The new investors as well as the existing players in any sector would prefer to invest if they see the existence of an impartial regulator looking after the interest of all the stakeholders. Thus, the governments around the globe create regulatory bodies to fulfill the need for expanding the infrastructure.

(vii) Private Capital

The availability or lack of availability of private capital is also a determining factor in the establishment of a regulatory mechanism in a given sector. In India after independence, the absence of private capital necessitated the growth and expansion of public sector. It was only after the expansion of private capital that the need for opening up a sector and establishing a regulator in the modern sense was felt.

(viii) Philosophy of the State

The underlying philosophy of the State has been undergoing changes from that of *laissez faire* to Welfare State to the withdrawal of State from non-essential functions. These changes in the philosophy have been impacting the role and level of the State to protect the interests of the consumers amongst others. The presence and strengthening of regulation has taken place in recent years owing to the concern of the State to protect consumer interests.
2.10 STEPS IN SETTING UP AN EFFECTIVE REGULATORY FRAMEWORK

According to Piyush Joshi, “The general steps in setting up an effective regulatory framework include:

(i) Establishing an agency with a firm foundation in law,
(ii) Limiting government intervention,
(iii) Setting up the agency well before privatization,
(iv) Ensuring financial and administrative autonomy,
(v) Hiring competent staff,
(vi) Establishing the process for appeal,
(vii) Giving the agency the means to enforce its decisions, and
(viii) Setting clear boundaries and links with other institutions”.34

2.11 SECTORAL AND MULTI-SECTORAL REGULATORY AGENCY

Most regulatory experts argue that there are some common elements that designers of regulatory agencies need to address. First, governments must decide on breadth of regulatory authority. In principle, regulatory authorities can be industry-specific with separate agencies for gas, water, electricity, and so on, as in the United Kingdom. They can be sector-specific with separate agencies for groups of related industries, such as for gas and electricity combined, as in Colombia and Hungary. Or they can be multi-sectoral with a single regulatory agency for all or most infrastructure sectors, as in the case of state-level regulators in the United States and national regulators in Jamaica. Most experts agree that a multi-sectoral agency offers advantages over the alternatives. The advantages include sharing of resources; facilitating learning across industries; reducing the risk of industry

and political capture; reducing the risk of economic distortions; dealing with blurred industry boundaries in a coordinated way.\textsuperscript{35}

Proponents of industry-specific agencies often argue that multi-industry agencies have weaknesses or limitations that offset their advantages. One concern is that a multi-industry agency may lack sufficient industry-specific expertise or focus. A second concern is that placing responsibility for several industries in one agency is tantamount to "putting all your eggs in one basket"; which would mean that the agency's failure would have costs for all industries. A third argument is that having a number of agencies allows experimentation with different approaches. Finally, it is sometimes suggested that multi-industry agencies are appropriate only for very small economies.\textsuperscript{36}

\section*{2.12 INDEPENDENT REGULATORY FRAMEWORK}

It is firmly held that an independent and accountable regulatory framework is absolutely must for promoting economic growth. This becomes all the more necessary because most of infrastructure services are inherently non-competitive and therefore, establishing a transparent and coherent regulatory regime can attract necessary investments to meet out the huge demand-supply gap and unlock economic growth potential. An Independent regulator is all the more needed to establish transparency and protect the interests of consumers particularly in not-so-competitive sectors such as the infrastructure services. In addition to tariff setting, the independent regulator has to look at achieving the other important objectives such as promoting competitiveness and efficiency, protecting consumer interests, maintaining quality of services, safety and so on.\textsuperscript{37}

This requires the regulator to stand as an independent policy advisor and adjudicator between the government and the aspiring private producers.

\begin{flushright}
\textsuperscript{37} CUTS Centre for Competition, Investment & Economic Regulation (C-CIER) and Planning Commission of India, op. cit.
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Independence is quintessential for the regulator; which means that the regulators needed to be financially independent, with specialized skills in the relevant area, and, free from capture either by the government's producer or by the private producer. At the same time Independent regulation poses a puzzle for democratic functioning; “As the power of the regulator increases, who is the regulator accountable to”? Now, as the regulator has adjudicative, legislative and executive functions but does not have the mandate of the people; one view is that the regulator should be exposed to public scrutiny, and that advisory committees may hold sessions in public. Another view is that a standing committee of the parliament and the relevant committee within the state legislature scrutinize such recommendations, wherever necessary. Thus, independence and regulation must come with checks and balances to reduce the probability of regulatory capture.

Further, in order to ensure independence of regulatory authority and effective regulation, it is essential to spell out a regulator's role in an unambiguous manner; to impart functional independence for regulators, including the power to determine the nature and strength of its staff as well as to appoint consultants; to give them financial autonomy, which can in turn substantially enhance their functional independence; to provide with the necessary wherewithal to perform the job effectively.

When agencies are to be independent, the goal should be to select regulators with the personal qualities needed to exercise independent judgment and resist improper pressures or inducements. The selection is critical, particularly for new agencies that have yet to establish a reputation for competence and reliability. Qualifications and disqualifications for appointment are usually set out in the law establishing the agency. Disqualifying factors generally include having a financial interest in regulated firms, which creates a conflict of interest. A common qualification required is significant experience or training in economics, finance, law, public administration, or industry.

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39 Regulatory Capture is a phenomenon in which a government regulatory agency becomes dominated by the interests of the industry it oversees (http://en.wikipedia.org/wiki/Regulatory_capture)
40 CUTS Centre for Competition, Investment & Economic Regulation (C-CIER) and Planning Commission, op. cit.
Another view is that the decision-making body should be composed of representatives of consumers and regulated firms rather than technical experts.41

According to Smith, “independence needs to be reconciled with measures to ensure that the regulator is accountable for its actions. Checks and balances are required to ensure that the regulator does not stray from its mandate, engage in corrupt practices, or become grossly inefficient. Striking the proper balance between independence and accountability is notoriously difficult, but the following measures to do so have been adopted by a growing number of countries:

(i) Mandating rigorous transparency, including open decision-making and publication of decisions and the reasons for those decisions.

(ii) Prohibiting conflicts of interest.

(iii) Providing effective arrangements for appealing the agency’s decisions.

(iv) Providing for scrutiny of the agency’s budget, usually by the legislature.

(v) Subjecting the regulator’s conduct and efficiency to scrutiny by external auditors or other public watchdogs.

(vi) Permitting the regulator’s removal from office in cases of proven misconduct or incapacity”.42

The institution of Independent Regulatory Commissions qualifies most of the above-mentioned requirements of independent regulatory framework. These commissions enjoy a material degree of independence from the executive branch of the government and substantial access to expertise on


77
the subjects of remit to them.\(^43\) It is relevant to mention here that USA had introduced the Independent Regulatory Commissions for the first time in the world in 1887 when it set up the Inter-State Commerce Commission. Other federal commissions include The Federal Trade Commission (1914); Food and Drug Administration (1931); The Federal Communications Commission (1934); Federal Aviation Administration (1948); Federal Highway Administration (1966); Occupational Safety and Health Administration (1970); Environmental Protection Agency (1970); Mine Safety and Health Administration (1973); Nuclear Regulatory Commission (1975).\(^44\) The US model of Independent Regulatory Commissions is adopted across the globe.

### 2.13 EFFECTIVENESS OF A REGULATOR

The above analysis reveals that the effectiveness of the regulator would depend upon a number of factors. The important among these factors include (See Figure 2.4):

1. **Independence From Political Pressure:** In order to ensure effectiveness of a regulator, it becomes paramount that its day to day functioning is not impacted by the political pressure. Independence from political pressure would give enough confidence and space for the regulator to carry its tasks in an efficient and effective manner.

2. **Financial Independence:** Regulatory governance is evolving and it has been realized that financial independence plays a very important role in determining the effectiveness of any regulator. Government control and attached purse strings – curbs the performance of a regulator, which has to look after the interest of all the stakeholders in the sector. Driving the salaries and expenses of the regulator from the sector itself – is an approach which is being recommended by the experts on regulatory governance.

3. **Competent Regulators and Regulatory Staff:** Competent and well-qualified regulatory staff are essential for the effectiveness of

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\(^{44}\) Rosenbloom, *op. cit.*, pp. 354-360.
regulatory bodies. In India, many Commissions are finding it difficult to fill critically important posts. With the low level of salaries offered by the regulatory bodies, they are unable to attract the required talent. Another problem with the recruitment of the regulatory staff is in the composition of the staff members. It has been seen that most of the technical staff members are from the regulated utilities and on deputation. This raises serious questions about the independence of the staff members and their ability to carry out fresh analyses. The lack of permanent staff would result in the problems because there will not be an 'institutional memory' at these bodies on important issues requiring frequent re-learning resulting in a lack of consistency in the approach used by them from one case to another. Further, temporary staff are most likely to 'toe the line' laid down by the Commissions and are less likely to be committed and accountable.

4. Accountability of the Regulator: Regulators must be accountable for their actions. Several features of the regulatory and policy framework are designed to make the regulators accountable for their actions: (a) transparency in the regulatory decision-making process with particular emphasis on the requirement for the regulators to clearly state the reasons for their decisions; (b) avenues for aggrieved parties to appeal regulatory decisions; and finally (c) procedures for dismissal of regulators for improper conduct. In addition, there is often oversight by the legislative or executive branch of the government. Accountability of regulatory bodies can be ensured through an audit of their accounts and expenses. However, it should be made clear to the auditing body that the audit should be limited to accounting issues and expenditures, and should not cover substantive issues such as the impact of specific decisions of the regulatory body on the economy.

46 Ibid., pp. 158-159.
47 Ibid., p. 162.
5. Transparency in Decision-Making: The regulator should not only perform its functions in an unbiased and objective manner, but equally importantly it should be seen as one. Open and transparent functioning in decision-making inspires the confidence level of the investors and the consumers alike. Even a hint of development of cozy and unnatural relationship between the regulator and the regulated; the phenomena which comes closer to the ‘regulatory capture’ – would severely dent the image of the regulator.

6. Effective Consumer Participation: Regulators are supposed to balance the competing interests of various stakeholders in arriving at a
decision. In order to ensure that a regulatory body arrives at a well-
balanced decision, it is very important that it hears from all the
stakeholders. However, in India consumer participation in regulatory
proceedings has been very weak. Representatives of small consumers
generally do not participate in proceedings, and even when they are
present they lack the technical expertise and financial resources to
effectively represent their point of view. This is in stark contrast to
countries like the US, where consumer advocates are one of the main
players in regulatory proceedings and where they come with their own
set of experts to represent their views.48

7. Functional Independence: In order to be effective, regulators need to
be – and perceived to be – insulated from improper influences. This
requires an arm’s length relationship not only with regulated firms,
consumers and private interests, but also an arm’s length relationship
with political authorities.49

8. Competitive Neutrality: Competitive Neutrality is about adopting
policies, which establish a ‘level playing field’ in areas where public
sector competes with the private sector. In practice, it is difficult to
ensure competitive neutrality in sectors where government or its
agencies retain control or insist upon retaining control. Furthermore, so
long as a regulator remains vulnerable to the discretionary powers
exercised by officials of a ministry to who state-owned incumbents also
report, it would be difficult to expect the regulator to ensure competitive
neutrality between the state-owned incumbent and other private
operators. For instance, the Indian telecom regulator, TRAI has not
been successful in reining the market power of the state-owned
incumbent: Bharat Sanchar Nigam Ltd (BSNL), which has thwarted
many decisions that are critical for competition to thrive, remain
unimplemented for a variety of reasons including litigation by BSNL.
Incidentally both TRAI and BSNL report to the Communications
Ministry.50 There are also cases of reverse competitive neutrality i.e.

48 Ibid., p. 162
49 Smith (1997 b.), op. cit.
50 Mehta; Agarwal; and Singh (2007), op. cit., pp. 27-28.
where private sector is in a relatively advantageous position as against public sector enterprises. For instance, for several years, public sector airlines in India were trying to procure aircrafts to expand their fleet; their proposals were doing the rounds of the government departments in search for a final approval. At the same time, private sector players were expanding their fleet size and grabbing a larger share of the market, at the cost of the public sector incumbent.

2.14 REGULATORY CHALLENGES

Regulatory institutions are new in India, and initially, these institutions are likely to face hostility from vested interests that may be threatened by the introduction of these institutions. In order to ensure the success of these institutions, it is important that during their nascence the government acts in a way that enhances their legitimacy.51

Regulating government-owned entities is difficult. First, the management of these companies has very different objectives from that of private companies, and increasing profits is not one of them. In fact, where subsidies from the government are readily available, financial incentives or penalties imposed by regulators on these entities are ineffective. Regulation of these enterprises is further complicated because with the government owning many of the regulated assets in the infrastructure services sector, there is a conflict of interest with the government being both the regulatory policy-maker and the regulated body. Because the government can put subtle pressure on regulators to shape their decisions to its liking, there is a perception that regulators may favour the government-owned enterprise.

Utility regulators should be established as long before privatization as possible, even if their formal powers do not come into effect immediately. This allows regulators time to familiarize themselves with their new responsibilities, to establish their offices, and to undertake any necessary training. It also provides assurance to consumers that their interests will be protected after

privatization and gives potential investors an opportunity to assess the regulatory system before formulating proposals.

Most new regulatory agencies can expect a challenging infancy. Besides mastering complex technical issues, regulators must define new and often difficult working relationships with political authorities, regulated firms, consumers, and other stakeholders. In countries in which the requisite skills are scarce, regulatory experience is limited, and there is little tradition of independent public institutions, the challenges can be daunting. And life is not made easier for a regulator if privatization remains politically contentious and if the first public evidence of its effects is a price increase allowed by the regulator.  

To meet these challenges, regulators must have adequate training; not only in such traditional disciplines as law, finance, and economics, but also in negotiation analysis, media relations, and the like. Regulators may also need technical support during the first months in office. Such support is often provided by consultants acting to some degree as “shadow” regulators. No less important, newly appointed regulators benefit from contacts and exchanges with more experienced regulators from other countries. Some of these contacts occur on an ad hoc basis, through visits and participation in conferences. But there is also an encouraging trend toward systematizing such contacts, for example, through a “twinning” arrangement between a new regulator and a more experienced foreign regulator. These arrangements can provide a basis for exchanging staff and materials or providing other forms of support and advice. There has also been a recent trend toward creating “networks” of regulators, such as the International Forum for Utility Regulation sponsored by the World Bank.

2.15 CONCLUDING OBSERVATIONS

The regulatory governance has undergone transformation from the early regulation by the State to de-regulation resulting because of its stifling effects to the need for regulatory governance in the de-regulated environment

52 Warrick Smith (1997 c.), op. cit.
53 Ibid.

83
necessitated mainly because of the entry of private players in the core areas of the infrastructure. The regulatory governance fulfils the essential tasks of balancing competing interests; controlling prices; protection of consumer interests; promoting competition; expanding the sector; ensuring quality of service; and ensuring access to all or equitable distribution of services to name a few. However there are certain factors which are necessary for the smooth functioning of regulatory governance. These include independence from political pressure; financial independence; competent regulators and regulatory staff; accountability of the regulator; transparency in decision-making; effective consumer participation; functional independence; and competitive neutrality. The biggest challenges for regulatory design are achieving political independence and introducing rules to ensure accountability. Political independence requires a commitment by the government early on in the process and accountability requires robust procedural and sound accounting rules.