



# Political Economy of Regulation

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# Outline: some institutional design problems

- ▶ The Pigouvian view of regulation: a modern reinterpretation
- ▶ The Chicago critique and its impact: US versus EU approach
- ▶ The enforcement theory of regulation and institutional architecture
- ▶ Some practical consequences: statutes and conduct of the regulator
- ▶ The regulator and the institutional system: relationships with executive, legislative and judicial systems
- ▶ Importance of building networks and reaching out to civil society
- ▶ Some case studies

*I use the term regulator for both competition authorities and sector regulators  
I concentrate on economic regulation and not general technical regulation  
e.g. on health and work safety, contract rules, transport rules, etc.*

# Role of regulation in a democratic market economy (Pigouvian view)

- ▶ Regulation is a set of rules, norms and institutions endowing a certain authority to intervene in the market place to resolve a market failure or restore rules for an efficient market. Objective is **maximizing consumer surplus in the short and long term**, specifically: (i) aligning incentives among economic agents, (ii) efficiency pricing cum social concerns, (iii) ensure incentives for investment and innovation (Pigouvian view)
- ▶ Regulation should clarify property rights, allocate them sensibly, and assure private investors that they will not be subject to regulatory opportunism
- ▶ Protecting interests of both consumers and investors is crucial to attracting the long-term private capital needed to secure adequate, reliable infrastructure services and to getting social support for reforms
- ▶ Privatization, liberalization (deregulation+competition) and regulatory reforms led to a more competitive, innovative and efficient telecom industries and infrastructure services in the last 30 years across the world. However, problems remain and challenges for the future are substantial

# Limitations

- ▶ In a competitive economy with a sustainable general equilibrium, regulators could achieve a Pareto optimum by enforcing pricing equal to long-term marginal costs or a two-part tariff structure a la Boiteux in case of market failures. A second best may be the only solution if redistribution is very costly.
- ▶ But the world is more complex: (i) asymmetric information among regulator and regulated and incentive compatibility, (ii) uncertainty about future states and technological developments, (iii) difficulties in identifying and quantifying externalities, and (iv) social and income distribution concerns. (Laffont-Tirole and others)
- ▶ Furthermore, wealth and income distribution are quite unequal, with well-know persistence problems. A small number of individuals may dominate the political structure, monopolize sectors (particular concern for nontradables). Political decision functions may be distorted in favor of those powerful interest groups. It is well known that in those cases regulation is usually either ineffectual and may even further distort allocations. **This is the domain of political economy.**

# Complementary roles of regulation and competition

- ▶ Economic (distinct from technical) regulation is a state intervention in a sector to correct a market failure arising from a natural monopoly (telecom, energy), barriers to entry and switching costs, or asymmetric information (financial). It acts a priori, requires continuous monitoring and is intrusive in management (carried out by NRA)
- ▶ Competition law is a set of rules for market players, that prevents and sanctions abuses of market power, across all sectors. It acts a posteriori (except for merger control and coordination contracts), once behavior is observed, relies on dissuasive power of sanctions. It is the least intrusive possible of management (carried out by NCA)<sup>1</sup>

# Chicago critique: importance of “creating” competition and the role of private litigation (US v. EU approach)

- ▶ Chicago critique: regulators are subject to capture by political and economic interests (Stigler, Posner). Numerous cases show (some illustrated here) its relevance
  - ▶ Shows importance of need of competitive market structures and democratic regimes
- ▶ Tendency for regulation to be designed to benefit relatively small groups with strong preferences relative to big groups with weak preferences. Pro-producer tendencies are disciplined by consumer groups meaning that price is less than the monopoly level.
- ▶ Regulation most likely in oligopolistic industries with dominant players as there is strong incentive for one group to lobby for regulation.
- ▶ Chicago proposals: Coasian approach – create conditions for solving market failure by negotiation of contractual arrangements. Very important insight: structural competition should eliminate the need of regulation (present view of the EU directives in telecoms)
- ▶ However: enforcement is not free; free rider problem prevents “collective user regulation” a la NZ
- ▶ Shleifer: enforcement theory of regulation – Litigation, central to the Coasian logic, emphasizes dispute regulation by courts; regulation emphasizes the enforcement of rules by the executive. The US system prefers the first, EU the second. Optimal mix is debatable and country-specific

# Enforcement theory of regulation

- ▶ Because enforcement of regulation requires: (i) scarce specialized resources in human capital, (ii) institutional capacity to pursue public interest and avoid capture, (iii) prevalence of competitive markets, (iv) democratic system to limit political power
- ▶ There are benefits and costs of different institutional arrangements. The solution for each country depends on pre-conditions (i)-(iv) (Mateus). While Shleifer argues that regulation has fixed costs we say that they are a function of institutional and education levels and while he argues that demand depends on population we say depends on GDP and alternative costs of enforcement
- ▶ E.g. in an undeveloped country maintaining a regime of free external trade is more important than having a competition authority (Laffont general low powered regulation is preferable to specific high powered one)
- ▶ The case of the US history also shows that a Regulated State (from the laissez faire Gilded Era to the Progressive Era) goes hand-in-hand with a market economy with democratic regime
- ▶ Studies by the author (i) global data show that only for countries above 10000 USD GDP per capita, regulatory regimes have a minimum level of enforcement, (ii) even within the EU the levels of regulatory enforcement differ significantly – problem of level-playing-field (uses data of regulation of competition)

# Practical consequences (I)

- ▶ Since the task of the regulator is to solve the market failure and restore some form of optimality in the market, its task is mainly economic and technical.
- ▶ Thus, the regulator should be guided by a set of principles defined by technical and scientific models and rules, dictated by mainstream economics and technical knowledge
- ▶ Consequently, the behavior, decisions and performance of the regulator should be dictated by the statutes of the authority and the mainstream (widely accepted) body of knowledge
- ▶ Under this theory, the regulator should be independent and accountable within these set of norms and principles

# Practical consequences (II)

- ▶ This means that it should not be subject to political pressure of the Government or any pressure group.
- ▶ But the temptation is great. Governments may want to retain last-world in certain decisions. E.g. public interest in mergers,
- ▶ Or, pressure groups may use media and politicians to influence the regulator.
  - ▶ Trade unions usually side with monopolies because workers share in the rents
  - ▶ Left parties side with trade unions (they rarely support antitrust policies)
  - ▶ Consumer associations are the natural allies (problems with their financing)
- ▶ Sometimes major decisions may affect decisively the future of a given company or interest group, so any action that may influence the decision of the regulator may pay-off
- ▶ What countervailing forces may help the regulator: (i) civil society at large, (ii) consumer organizations, (iii) off-setting economic and political groups. To what extent the regulator should seek its help? What activist role of the authority – Media and Info Department?

# But is this realistic? How to avoid regulatory capture?

- ▶ Paramount importance: choosing the Board. Boards are usually nominated by the Government, and such a decision makes them dependent. Additional risk: re-nomination.
  - ▶ Boards should be eligible only for 1 single term of 5-6 years, choose members at end of their carriers. Prohibition to take a job with conflict of interest for 2-3 years
  - ▶ Set-up a Supervisory Board composed of independent and reputable persons
  - ▶ Board nominated by an independent Committee with competitive bidding
- ▶ Independence: political, administrative and financial
- ▶ Political independence should be defended by the civil society and academic community (and Parliament)
- ▶ Administrative independence should lead to discretion in choosing and prioritizing cases (efficiency principle), conducting investigations and taking decisions. But the parameters of personnel and resources need control by Executive and/or Parliament. Role of the Audit Committee
- ▶ The best way to ensure Financial independence is to specify an automatic rule. E.g. tax on regulated, a general tax on transactions and fees for operations. Tax on the spectrum?

# Accountability

- ▶ Strategic Medium Program and annual Business program approved by the Supervisory Board, and scrutinized by Parliament and General Accounting-Audit Body
- ▶ Maintaining a transparent and user friendly site with up to date information with mission statement and working plans. Publish all the decisions (only purged of commercial sensitive information)
- ▶ Press releases of all major decisions
- ▶ Promote the culture of regulation by participation of the Board on seminars, interviews and public debates (but maintain a high level of discretion on future decisions and on-going cases)
- ▶ Economic research on the issues dealt by the regulator (to inform future decisions and on-going cases)

# Other requirements for effective regulation

- ▶ Have competent, nonpolitical, professional staff – expert in relevant economic, accounting, engineering, and legal principles and familiar with good regulatory practices
- ▶ Operate in a statutory framework that fosters competition and market friendly regulatory policies and practices
- ▶ Be subject to substantive and procedural requirements that ensure integrity, independence, transparency, and accountability

# Some methods of regulation are less prone to pressure (capture)

- ▶ Ex-ante competitive and efficient auction systems to extract rents from natural monopolies, avoiding pressure ex-post
- ▶ New methods like benchmarking can also be beneficial
- ▶ In issuing new licenses Gov should conduct also auctions less restrictive as possible
  - ▶ E.g. in new electricity supply use an auction for least price but technology neutral
- ▶ In periodic utility price settings NRA should define clearly and publish methodologies, conduct open sessions and submit decisions to civil society (including supervisory body) scrutiny before adoption

# But every decision of a public body is political and has political implications

- ▶ The regulator should deal with all political parties on a neutral basis
- ▶ It should have a specific voice in the media (what is the appropriate presence and what message should convey: consumer welfare orientation)
- ▶ Seek alliances in the civil society, establish close links with specialized groups in the Universities
- ▶ Importance of international links: within EU and globally
- ▶ In decisions involving several parties, when the decision favors one group or enterprise, the agency should be careful in not expressing any favoritism (usually the media exploits these points)

# What relations with the Executive?

- ▶ Governments have the right to define all policies, and sometimes defines an industrial policy. What are the limits?
  - ▶ In Germany The Gov approved, reversing a decision of the CA, merger of Eon and RuhrGas (2003)
  - ▶ Portuguese case of merging the electricity and gas incumbents quasi-monopolies was almost approved by the EC, but finally rejected (2004)
  - ▶ Spanish case of hostile takeover of a major electricity producer, Endesa, by gas distributor, Gas Natural (2005)
    - ▶ After a fight with the EC was considered a Spanish case: decision by national regulators (interpretation of the 2/3 rule of turnover)
    - ▶ The Spanish CA was against and the law was changed so the sector regulator could authorized
    - ▶ Did not materialize because stockholders problems of the electricity company (takeover by Italian electricity company). Later Gas Natural merged with Fenosa, largest distributor of gas and 3<sup>rd</sup> in electricity
- ▶ But, the CA and sector regulator should exert their authority to the full in the statutes
- ▶ Unique opportunity to establish independence



The Endesa case was certainly a political football. Endesa has threatened to take the case to the Court of First Instance in Luxembourg and the Spanish centre-right PP party accused Commission president Jose Manuel Barroso of allowing the deal to be handled by the Spanish authorities in return for Spain lowering its demands for EU aid. Barroso called the claims “absurd” and said the decision was made purely on technical and legal grounds. Spanish legal experts agree that the claim is

Financier Worldwide, January 2006

# How Governments influence market structures (more)

- ▶ In most of the EU countries licensing policies have influenced more market structures in energy markets than NCA or NRA
  - ▶ By controlling entry and allocating licenses Gov have a major opportunity to make market structures more competitive (e.g. in Portugal the NCA proposed that licenses for new capacity should be allocated to others than incumbent, but was not uphold)
- ▶ Structural policies like unbundling can also be powerful policies, interconnection in energy markets, roaming in telecoms
- ▶ Gov also intervene in price regulation for political reasons, despite European Commission and “state aid rules”
  - ▶ In 2007 the Socrates gov stopped the decision of the NRA to increase prices in electricity for political reasons, changing the rules. “Tariff deficit” accumulated of more than 3 Billion Euros
  - ▶ Spanish gov rebalanced tariffs to reduce prices to large industries
  - ▶ Need to revise concept of “state aid” to incorporate these cases

# What relations with Legislative?

- ▶ Usually an easy relationship
- ▶ Parties in power support in general the authorities, except if there was a divergence with industrial policy, and in this case opposition parties may exploit the divergence: major discretion is advisable
- ▶ Authorities should use Parliaments to explain its activities and major decisions, the media is usually present and is a good opportunity for the authority to use its voice
- ▶ MPs may put directly questions to the authority: it should be responded in a timely and competent way

# What relations with Courts?

- ▶ Sometimes cases are upheld and sometimes they are either changed (fines reduced) or decisions simply annulled for formal or content reasons
- ▶ The authority should have the highest discretion in dealing with courts, availing commenting directly decisions of the courts
- ▶ It should be left to academics
- ▶ The problem is when lawyers exploit these decisions for marketing purposes: OK if both parties intervene, but a lawyer that wins a case against the authority has the highest incentive to “celebrate”
- ▶ How can the authority defend itself?

# Importance of building networks

- ▶ Building a network of domestic regulators
- ▶ The EU network
  - ▶ Pros-reduces threat of national gov interventions
  - ▶ Help build a common approach and EU market
  - ▶ Problems with harmonizing enforcement
  - ▶ Cons-may limit innovators and fast track
- ▶ International/global networks
  - ▶ Cross-continent interflows
  - ▶ Exchange of experiences (EU with US and other developed jurisdictions)
  - ▶ Help build up capacity of least developed regulators

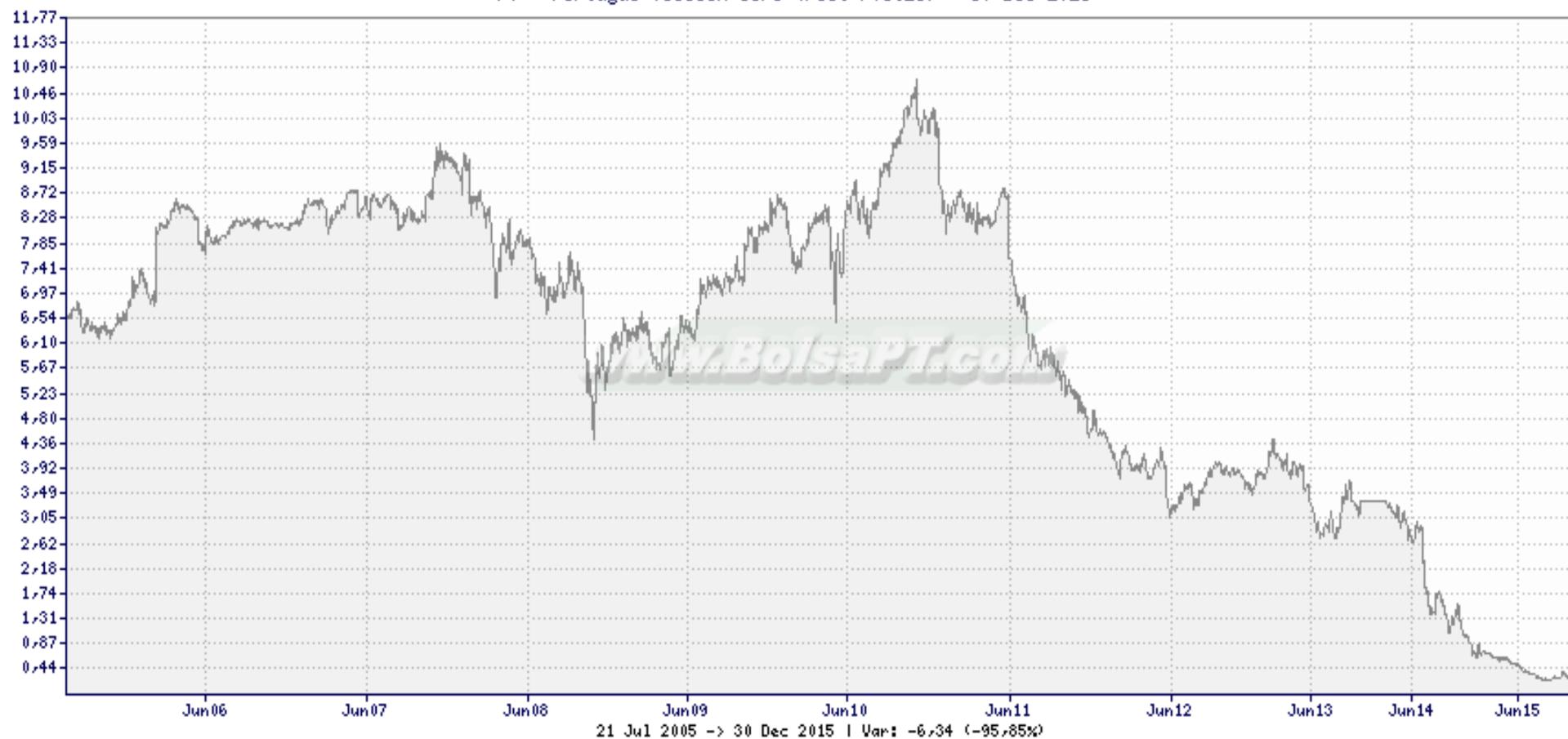
# Need to improve institutional architecture: example of merger control

- ▶ At national level
  - ▶ Competition authority decides based on competition (SLC test)
  - ▶ Sector regulator can veto in exceptional circumstances, eg. If the merger threatens financial stability, plurality of views in media
  - ▶ National security concerns can also veto the merger
    - ▶ Law on national security establishing rules: control of strategic assets by a “non-friendly” foreign government
    - ▶ Parliamentary Committee to enforce the law
  - ▶ With this structure there is no need of further government intervention based on “public interest”

# Case study

- ▶ PT was the incumbent telecom monopoly. Privatized in the 1980s just with concern of maximizing Treasury intake.
- ▶ It owned two networks: copper used for land lines and latter for internet via ADSL; and cable to supply cable TV and latter internet. It also controlled largest media group.
- ▶ Situation in the early 2000s: (i) among highest telecom prices in EU, (ii) high level of inefficiency: 30% with a frontier pf methodology (Greene study), (iii) controlled by BES group, which had substantial benefits, despite minority stake, (iv) expanded to Brazil in a major investment operation (1/3 of assets) with high leverage buying a mobile operator in Sao Paulo region, and minor operations in African countries, (v) substantial links with political establishment. Two other companies made some inroads in the markets: SONAECOM (linked to Azevedo group) and Cabovisão (linked to a Canadian firm). They had together about 20% of market share.
- ▶ PCA proposed a break-up in two: copper-based and cable-based telecom companies. Because it was difficult to implement a break-up based on cases of dominant position (more than 20 claims by entrants), the case was made to the Government. PM talked of a spinoff in an interview in mid-2005.

PT - Portugal Telecom SGPS (PSI: PTC.LS) - 30 Dec 2015





- ▶ Sonaecom launched a take-over bid (about 16 BE) backed by financing from Santander (mid 2005) with commitment to spin-off one of the networks and media group. PCA approved the take-over (Sept 2006), regulator was reluctant but was over-ruled because decision was of the PCA. Government was against, and used state bank to vote against. BES used an alliance of investors to vote against. Spanish Telefonica was in favor.
- ▶ Take-over bid failed, but due to Government pressure PT made the spin-off of cable network to the same stockholders. Limited competition.
- ▶ PT borrowed heavily and sold Brazilian subsidiary to reward stockholders (a promise made by the Board who voted against the bid). Sold 50% of share in Vivo to Telefonica for 7.5 BE in July 2010. At the same time bought another Brazilian telecom (Oi – 23% for 3.75 BE) and later they merged (PT becomes a subsidiary in April 2014). Oi was in bad financial situation (murky links with both Governments). Stocks plunged with Portuguese economic and financial crisis and when Oi was known to be in trouble.
- ▶ Further major crisis in 2013 due to large unsecured loan made by PT to BES financial group which was bankrupt, and integrated in Oi which was also in financial difficulties.
- ▶ Sonaecom merge with Zon in mid-2013, as BES sells its position in Zon. Later changes name to NOS.
- ▶ PT sold to French group Altice, in Dec 2014, for 5.6 BE, about 1/3<sup>rd</sup> of the price offered in the takeover. Renamed MEO. Today 3 major groups with Vodafone.

# The importance of regulation has not decreased and its relevance is higher today

- ▶ In our view, the global financial crisis that started in the subprime crisis in the USA was a massive failure of regulation and internal governance of major banking institutions
- ▶ The losses incurred with monopolized sectors in telecoms, energy, transport and other regulated sectors are huge across the world
- ▶ But even larger, are the losses in present and future income due to suboptimal GDP growth in these economies, due to misallocation of resources (e.g. Portugal and Greece in the EU)

# Conclusions

- ▶ Academics and policy makers need to dedicate more attention to questions of political economy of regulation
- ▶ An efficient and effective regulator requires a competitive market economy and democratic regime to limit market and political power
- ▶ Some simpler ways to insulate from political interference
  - ▶ Political, administrative and financial independence
  - ▶ Board nomination
  - ▶ Competent personnel (conflicts of interest)
  - ▶ Build bridges with academics, media and consumer groups (networking, EU integration)
- ▶ Structural competition is the best way to have efficient markets
- ▶ Use some high-profile cases to show relevance of regulation
- ▶ Above all: clear vision, strategic approach and high integrity and competence and dedication to public policy

# References

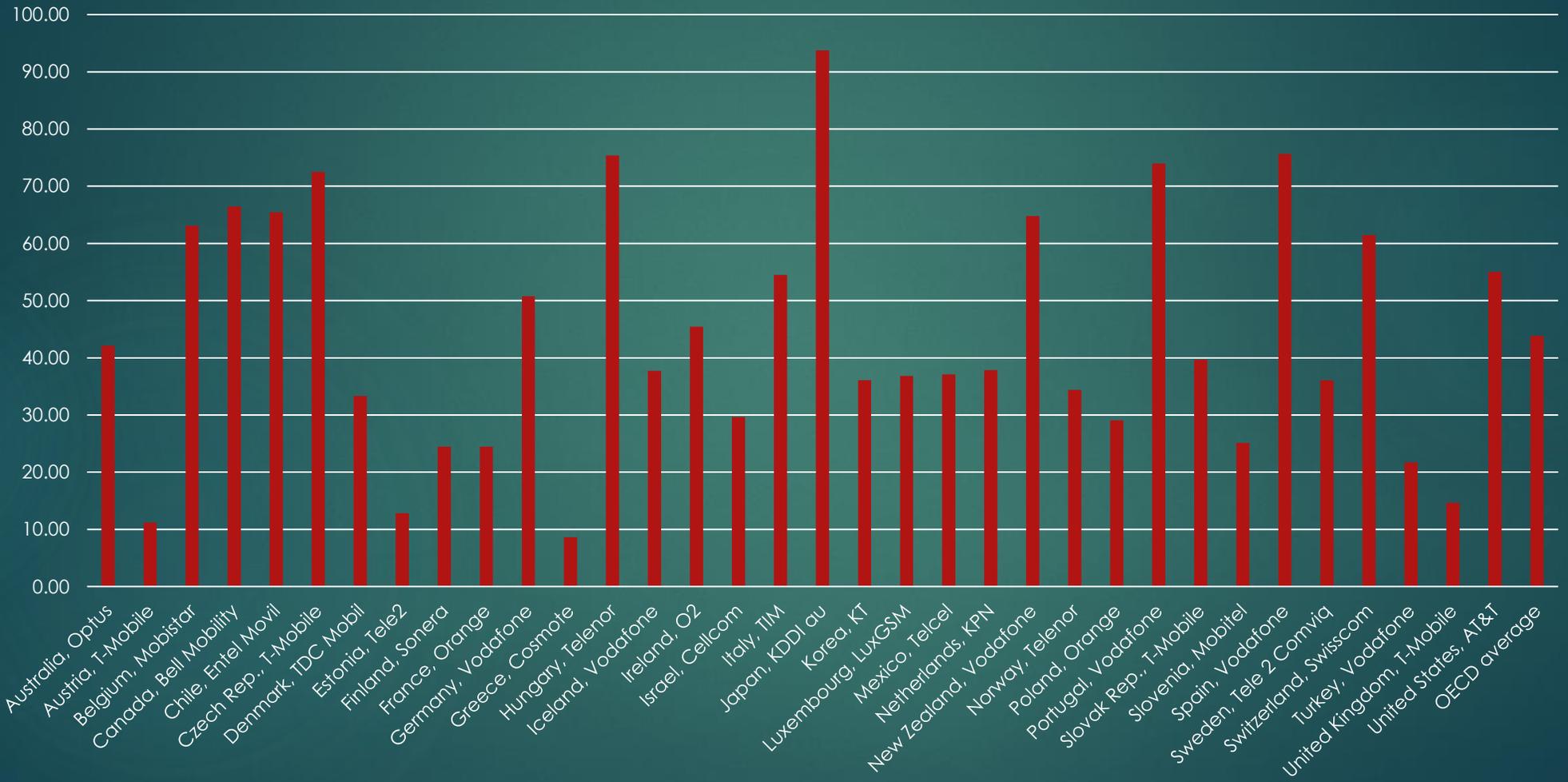
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# Issues for discussion

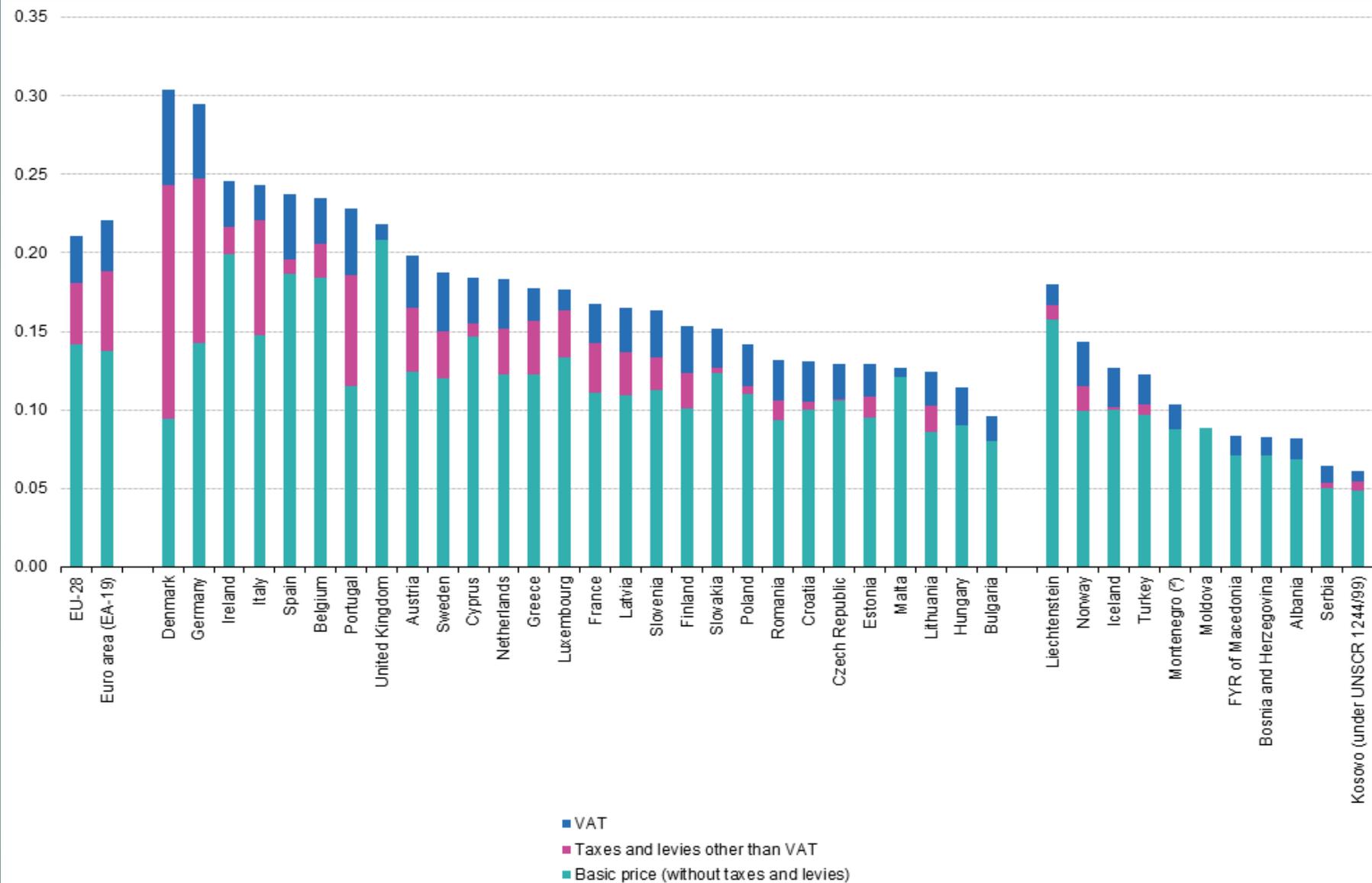
- ▶ Efficient and effective regulation requires a democratic market economy? Pigou, Chicago and Shleifer – competition, regulation and private enforcement: what mix? But a regulatory state is also part of a democratic market economy. Is it a pre-condition?
- ▶ Which Institutional framework for regulation? Independence is important, but with parallel accountability (not to be forgotten). Should regulators be subject to liability?
- ▶ Governance and the crucial role of the Board. How to choose a competent and effective Board. What commitments? What relationship with Government and Courts?
- ▶ Efficient regulation requires competitive markets. Sunset regulation?
- ▶ The evolving role of the frontier: technological, institutional and political elements. What relationship between regulatory agency and competition authority
- ▶ Litigation versus regulation
- ▶ The importance of a balanced and rigorous regulation (interventionist versus laissez faire), Chicago view. Some facts and myths



Prices mobile calls (USD, 300 calls, incl. VAT)



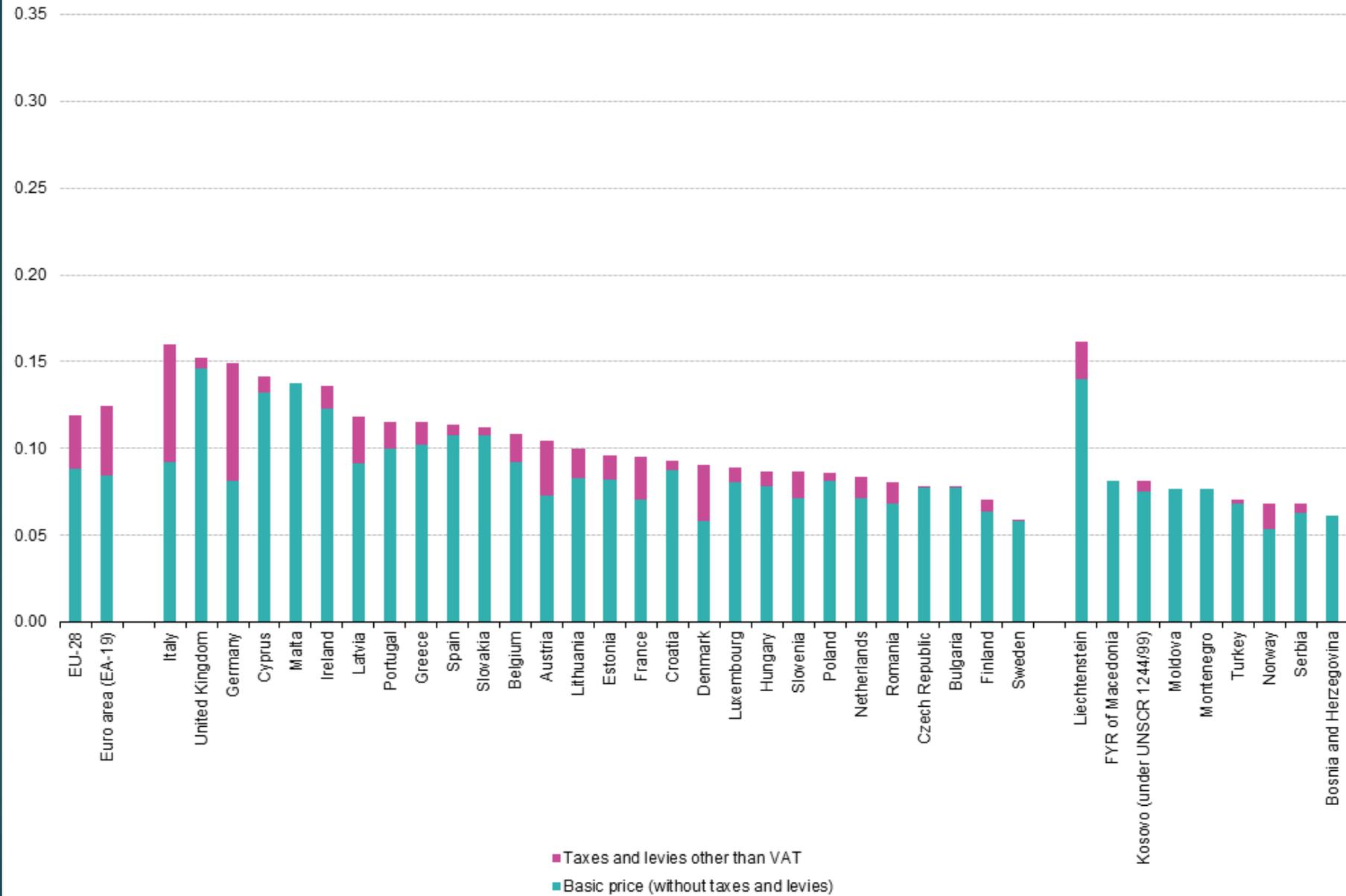
# Electricity prices households (2015)



(\*) Annual consumption: 2 500 kWh < consumption < 5 000 kWh.

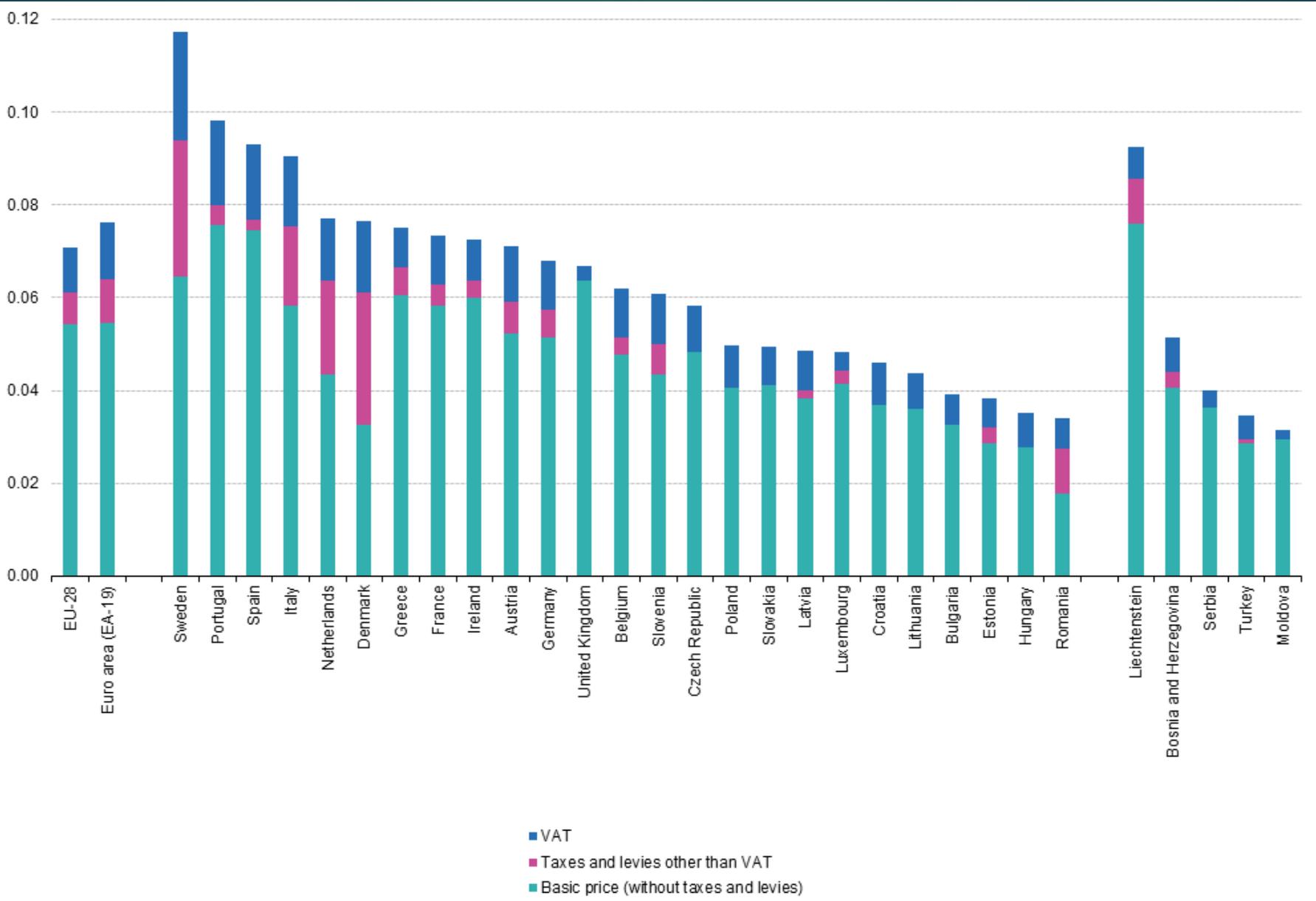
(\*) Taxes and levies other than VAT are slightly negative and therefore the overall price is marginally lower than that shown by the bar.

# Electricity prices industrials (2015)



(\*) Annual consumption: 500 MWh < consumption < 2 000 MWh. Excluding VAT.

# Natural gas prices households (2015)



(\*) Annual consumption: 20 GJ < consumption < 200 GJ. Finland: not available. Cyprus and Malta: not applicable.