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The Golden Age of Regulation

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It is often said that we live in an age of deregulation and that the state has been forced to retreat to reduce burdens on businesses. Under these statements is the belief that a decade of more of deregulation has reduced state intervention in markets. To be blunt, this is largely a myth, and one that interferes with efforts to improve the effectiveness of the state in protecting public interests.

Far from living in an age of deregulation, we live in the golden age of regulation.[1] From environmental protection to consumer protection, safety and health, labour standards, and social justice rules such as equal opportunity, no government activity in OECD countries has grown faster since 1980 than government regulatory functions. Even during the administrations of Reagan and Thatcher - the quintessential "deregulation" crusades - the quantity of regulations measured in number of rules and their length increased in both the United States and the United Kingdom. And regulatory constraints are becoming more stringent. Regulatory standards have never been higher in the developed countries than they are today. International standards are increasing rapidly.[2] That is not to say that they are keeping up with new risks and technological changes, but that is another argument entirely.

The number and scope of government (domestic and international) regulations have increased so rapidly in almost all OECD countries that the term "regulatory inflation" was coined by the OECD in the early 1990s.[3] Regulatory inflation is probably accelerating as decentralisation continues in countries like Spain[4] and Italy[5], since layers of government usually lead to new layers of regulations. In fact, the level of regulation is increasing so quickly that governments cannot possibly enforce all rules, nor can citizens and businesses comply.[6] Regulatory compliance is probably declining as regulatory inflation continues.

In the economic sphere, too, regulation is increasing. The essential difference is that new market regulations tend to be pro-competitive, replacing more costly and less effective forms of government intervention, such as state ownership.[7] It might be surprising that, in the United Kingdom, regulation grew fastest in the 1980s, the decade of privatisation. This is because large new regulatory regimes and institutions - such as Oftel and Offer - were established as the state changed its role from owner to regulator. Prime Minister Thatcher was the biggest regulator in UK history, appropriately for the biggest market liberaliser in UK history. The UK "Big Bang" in many

respects codified what had already been going on in practice, and moreover tightened up regulation in many respects.[8] The European Single Market programme - a market liberalisation programme whose value to sustainable European growth is often underestimated - is built on 80,000 pages of regulations that create the economic space for trade and investment.

The deregulation myth arose because liberalization in international capital markets and privatization in a few key infrastructure sectors such as telecommunications and to a lesser extent energy and transport released powerful new market forces, which became a symbol for generalized government retreat, though governments were actually building many new regulatory programmes and institutions. The idea that market liberalisation and deregulation are synonyms is misconceived, and when put naively into practice has led to regulatory gaps, market failures such as dominance, and consumer abuses such as safety hazards. For that reason, the deregulation myth is dangerous.

It is easy to dispose of another myth. The state is not withering away in the face of markets. If anything, the average size of the governments in the OECD area, measured in government revenues as a percentage of GDP, increased slightly from the mid-1980s to the mid-1990s. This is perhaps a natural consequence of the growing role of the state in insuring citizens against risks as dynamic markets increase insecurity and of welfare effects of aging societies.

A third myth, too, deserves deflating. It is often said that globalisation is driving market liberalisation at the national level. The popular story is that governments are doing just fine on their own, but are being forced into unwanted and harmful reforms by international pressures. In reality, most reform is driven by purely domestic needs: stubborn levels of structural unemployment, lagging growth rates, diversion of fiscal resources into propping up loss-making state-owned enterprises,[9] and consumer demands for innovations like mobile phones and cheaper services and products. Likewise, most benefits of reforms are enjoyed by domestic consumers and producers. It is for domestic reasons that supply-side reforms to stimulate competition and reduce regulatory inefficiencies have become central to effective economic policy. These policies would make just as much sense in a world where there was no trade and cross-border investment.

It is quite true that liberalisation has gone furthest in those two sectors - communications and financial services - mostly directly affected by global market integration. But many markets where reforms are occurring are not, in fact, very global. Reforms in areas such as taxis in Sweden, electricity in Japan, pubs in Ireland, government permits in Italy, pharmacies in Spain, water in the United Kingdom, and tortillas and land use in Mexico are

domestic reforms for domestic constituencies.

The real policy challenge today is not resistance against a ruthless programme of deregulation driven by markets. The challenge is to manage the quality, transparency, and effectiveness of the burgeoning regulatory state to ensure that the new kinds of regulations and institutions contribute to social and economic progress. The real problem may not be the size of the state (as suggested by those who focus on deregulation or regulation as a test of effectiveness), but the effectiveness of the state itself.[10] In some important areas, such as capital movements and investments, governments have lost substantial control of market decisions. For other reasons, regulatory tools are losing relevance to markets (as factors of production become more mobile and global, and as product cycles shorten) and to civil societies (as societies become more diverse, informed, and oriented toward choice). These forces - weighted against increasing regulatory interventions - must cause us to question traditional methods of state action, and look for new ways to harness markets in the social interest.

Box 1.**Regulatory reform in four OECD countries**[11]

In the Netherlands, regulatory reform has been important to the modernization of the welfare state and integration into the European single market. Dutch governments in the 1990s have sought a "new balance between protection and dynamism" based on competition policy, regulatory reform, and market openness. Regulatory and competition policy reforms in the Netherlands have helped to sustain and expand earlier gains from labor and social security reforms. At the same time, the economy faces new challenges from the completion, within the European single market, of deregulation of infrastructure sectors, from increasing globalisation, from the rapid pace of technological progress and the resulting structural change in OECD economies, and from population ageing. Regulatory reform can continue to play an important role in the policy response to these challenges.

The Mexican economy, heavily regulated and protected two decades ago, is now largely open and market-based. The rapid pace, broad scope, and depth of regulatory reforms in Mexico exceed those of most other OECD countries, and compare to those of the emerging market economies in Eastern Europe who recently joined the OECD. The challenge today is to consolidate the economic and institutional transformation so that Mexico can fully reap the benefits of an economy that is more efficient, competitive, and flexible. The role of international regulatory frameworks was critical in Mexico. Mexico's accession to the GATT in 1986, APEC in 1993, the OECD in 1994, and the negotiation of NAFTA and other free trade agreements acted as catalysts for

domestic regulatory reforms and provided strong policy anchors which minimized the adverse effects of the peso crisis in 1995 and helped Mexico stage an impressive recovery. After some setbacks in the aftermath of initial privatisation efforts due to the lack of appropriate regulatory frameworks, the Mexican government has shifted its attention to regulatory improvement and efficient re-regulation of certain sectors.

Significant regulatory problems still exist in the United States, but far-reaching economic deregulation combined with efforts to improve the quality of social regulation have contributed to one of the most innovative, flexible, and open economies in the OECD, while maintaining health, safety, and environmental standards at relatively high levels. This was not achieved by indiscriminate deregulation, rather, US regulation tends to be based on two fundamental regulatory styles that support economic dynamism and market adjustment: 1) federal regulation takes a pro-competition policy stance, supported by strong competition institutions. Regulators tend to prefer policy instruments, such as social regulation and market-driven approaches, that are competition-neutral over public ownership and economic regulations that impede competition; and 2) the openness and contestability of regulatory processes weakens information monopolies and the powers of special interests, while encouraging entrepreneurialism, market entry, consumer confidence, and the continual search for better regulatory solutions.

Regulatory reform has been prominent on Japan's political agenda since the Hosokawa government promoted deregulation as key to economic recovery in 1994, and has been a central element in the broad economic structural reform program underway since December 1996. The goals of regulatory reform are ambitious: to complete the move from a model of *state-led* growth - in which interventionist styles of regulation were used for decades to manage high economic growth, carry out deep structural reform, and promote producer interests - to a model of *market-led* growth characterized by a more efficient and flexible economy in which the role of the government is diminished and consumer interests take precedence. Sustained effort has reduced economic intervention in many sectors, including large retail stores, gasoline imports, telecommunications, and financial services. Consumers have already seen significant results. There is slow but steady movement toward more transparent and less discretionary regulatory practices, driven by market demands and by recognition of the gap between domestic and international practices. The framework for competition policy has been strengthened. The challenge today is to deepen and speed up the regulatory transition already underway, while managing its effects on economic and social life so as to sustain and expand political capacities for reform. The need for more rapid progress is urgent. Since 1992, the

Japanese economy has had the poorest performance in the G7. External shocks and cyclical factors have played roles in the current malaise, but the most important factor has been structural rigidities resulting from an increasingly outmoded regulatory and institutional framework. Without further reform, any economic recovery in Japan will likely be fragile and short-lived, and unemployment will remain high.

Endnotes

[1] Some of these arguments are taken from a more fully documented paper: Jacobs, Scott (1999) "The Second Generation of Regulatory Reforms," Paper presented at **IMF Conference on Second Generation Reforms**, 8-9 November 1999, Washington, D.C. The paper can be found at www.imf.org/external/pubs/ft/seminar/1999/reforms/jacobs.htm . See also the series of OECD multidisciplinary reports on regulatory reform in Japan, United States, Netherlands, Mexico, Spain, Korea, Hungary, and Denmark, which can be ordered at http://www.oecd.org/subject/regreform/

[2] See OECD (1994) **Regulatory Co-operation for an Interdependent World**, OECD, Paris

[3] For a discussion of regulatory inflation in OECD countries and its causes, see Jacobs, Scott, et. al. (1997) "Regulatory Quality and Public Sector Reform," (1997) in **The OECD Report on Regulatory Reform: Sectoral and Thematic Studies**, OECD (Paris).

[4]See OECD (2000) **Regulatory Reform in Spain** (Paris)

[5] OECD (2001) **Regulatory Reform in Italy** (Paris)

[6] OECD (2000) **Reducing public policy failures: challenges for regulatory compliance** (Paris – forthcoming)

[7] OECD (1997) **The OECD Report on Regulatory Reform** (Paris)

[8] Harris, Stephen L. and Charles Pigott (1997) "Regulatory Reform in the Financial Services Industry," in **The OECD Report on Regulatory Reform: Sectoral and Thematic Studies**, OECD (Paris).

[9] One side-effect of liberalisation is that it has allowed national resources to be used to support social programmes. Privatisation in the United Kingdom transformed many state-owned enterprises from drains on the national budget to tax-paying enterprises. In Mexico, privatisation and liberalisation has released substantial resources for investments in education and health care.

[10] Standard notions that higher state intervention is associated with lower economic efficiency are being revised. La Porta *et al.* (1998), point to work showing that the degree of intervention may not be as important as its quality. Higher taxes may, for example, be associated with better institutions. See "The Quality of Government," NBER Working Papers 6727, National Bureau of Economic Research, Cambridge, Massachusetts, p. 7.

[11] See OECD (1999) **Regulatory Reform in Mexico**, **Regulatory Reform in the United States**, **Regulatory Reform in Japan**, **Regulatory Reform in the Netherlands** (Paris)