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THE SECOND GENERATION OF REGULATORY REFORMS

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It has been said that predictions are difficult, particularly when they are about the future, but this is a good time to forecast the course of the likely second generation of reforms affecting the relationship of the state and the market. This paper focuses on future challenges, with an emphasis on regulatory reform since regulation is a pervasive policy instrument defining that relationship. There is little hard data to chart the way forward, so I will engage in what Keynes called "an essay in persuasion," an elegant term that allows one to proceed in the absence of robust evidence. What data there is suggests that the conclusions in this paper may not be readily generalized to every kind of setting, since they are based on the experiences of the world's most industrialized countries.

This paper makes two main points: 1) the first generation of reforms -- the transition to market-led growth -- has produced enormous benefits in those countries where they are most advanced, but it is far from complete; and 2) second generation reforms are necessary to re-align fractured relations between the institutions of the state, the market, and civil society to sustain market-led growth and boost potential social welfare.

The transition from state-led to market-led growth is far from complete….

Discussion of the second generation of reforms should not distract attention from the urgent and difficult task of moving forward with the first generation of reform: the transition from state-led to market-led growth. This transition marks a shift away from the *dirigiste* and interventionist models that developed in many countries in post-war years as part of the comprehensive welfare state. First generation reforms aim at revitalising market functioning through economic liberalization and market opening, including withdrawal of the state from ownership and from intervention in market entry, market exit, and pricing.

In the OECD countries where first generation reforms have been broadly applied for a decade or more, the results have been a triumph of competition. The wealth, innovation, and competitive advantage created by these reforms launched a multi-decade process of market-oriented reform that is now a worldwide phenomenon affecting the lives of billions of people. In many countries, these reforms to the roles of the state and the market, in combination with technological changes and global opportunities, are just now beginning to change the structure of markets and methods of production. If the experiences of these pioneering OECD countries can be replicated, we have not yet seen even a substantial fraction of the possible benefits of this transformation. First generation regulatory reforms, within the right institutional framework, could be among the most significant of the policies aimed at alleviating global poverty and inequities.

As a result, supply-side reforms to stimulate competition and reduce regulatory inefficiencies have become central to effective economic policy. Building on work that has been underway for many years, the OECD's 1997 *Report to Ministers on Regulatory Reform*,[2] and our current program of

1. These views are those of the author, and not necessarily of the OECD.
2. OECD (1997), *The OECD Report on Regulatory Reform*, Paris.

multidisciplinary assessments of the directions, results, and future of regulatory reform in individual countries,[3] are documenting the benefits and costs of these supply-side reforms (Box 1 summarizes the reviews of regulatory reform in Japan, Mexico, the Netherlands, and the United States).[4]

These assessments demonstrate how, against a backdrop of basic market rules, a comprehensive approach to regulatory reform across related policy areas creates positive synergies. Liberalizing trade, empowering market competition, and reforming government institutions are mutually supportive elements of the first generation of reform. Stable macroeconomic policy, flexible labor markets, appropriate regulation of capital markets, and complementary structural reforms provide a supportive environment, and often a context of strong growth, that facilitate adjustments that follow from regulatory reform. A multi-sectoral approach also boosts gains, since the benefits of sectoral reforms are amplified when competition is vigorous in upstream and downstream sectors. The major benefits of regulatory reforms have been:

- *Boosting consumer benefits* by reducing prices for services and products such as electricity, transport, and health care, and by increasing choice and service quality.

    - In the United States, the effects of sectoral reforms are still working their way through the economy, but the medium-term results are clear: in every major sector, the results for consumers in terms of prices, quality, and choice are solidly positive. Reform in several sectors is providing annual benefits to US consumers and producers of between $42 billion and $54 billion. Prices declined primarily because real operating costs fell in most sectors by 25 to 75 per cent.[5] Gains were seen in all types of productivity: labour, capital and TFP. Service quality generally improved. Concerns that reform would reduce safety are not borne out, probably because regulatory protections were not reduced in reformed sectors, though consumer concerns remain high in health care, telecommunications, and air travel.

    - In Japan, efficiency gains from deregulation are estimated to boost consumer income by about 0.3 per cent per year, or $36 billion annually. The hidden cost of weak competition in many sectors can be seen in the fact that Japanese price levels in 1993 were the highest in the OECD, 56 per cent above the OECD average,[6] particularly in prices for non-traded goods in cartelised and highly regulated sectors. Regulatory reform has begun to reduce prices: prices for national long-distance and international telecommunication services fell by 77 per cent through 1996 and reforms in distribution lowered prices by one per cent annually since 1990. The gap between Japanese and foreign prices seems to be declining due to substantial improvement in prices in deregulated sectors; prices in these sectors showed a four per cent greater improvement between 1990-95 than in regulated sectors.[7]

- *Reducing the cost structure of exporting and upstream sectors to improve competitiveness* in regional and global markets. Increased efficiency had particularly high payoffs for small open economies such as the Netherlands. Improving productive efficiency by reducing costs for critical inputs such as communications, land, and transport services boosted the growth of Mexico's export sector. Reform

3. OECD (1999), *Regulatory Reform in Japan*, Paris; OECD (1999) *Regulatory Reform in Mexico*, Paris; OECD (1999), *Regulatory Reform in the Netherlands*, Paris; OECD (1999), *Regulatory Reform in the United States*, Paris.
4. The OECD is reviewing four more countries in 1999.
5. Winston, Clifford (1998), "US Industry Adjustment to Economic Deregulation", *Journal of Economic Perspectives*.
6. The 1993 *OECD Survey* cites evidence that Japanese prices at the time were on average 20 per cent above the OECD average, particularly in food and beverages, fuel and power, transportation, communications and services.
7. Government of Japan Economic Planning Agency (1997), 1997 Price Report, October.

also enhanced investment. Inward investment in Japan grew fastest in deregulated sectors such as distribution, financial services, and telecommunications. A supportive effect of regulatory reform is to expand the scope for trade. In Japan, regulatory reform reduced trade tensions due to possible regulatory barriers, and improved the trading environment.

- *Addressing a lack of flexibility and innovation in the supply-side of the economy*, which will be an increasing constraint to growth. In the United States, we found that dynamic effects of market-opening were more important than anticipated; in fact, gains from innovation were usually more important than static efficiency gains. An extraordinary surge in innovation and faster introduction of new technologies, services, and business practices multiplied benefits for consumers and produced new high-growth industries. Direct and indirect effects of sectoral reform helped increase flexibility in the labour market and elsewhere. These effects allowed the US economy to adapt more quickly to changes in technology and to external shocks, improved the trade-offs between inflation, growth, and unemployment, and boosted the US lead in productivity. The greater responsiveness of the Mexican economy after the 1995 recession, compared to earlier recessions, reflects the increased openness of the economy and enhanced flexibility engendered by structural reforms, as well as the international advantages of stronger domestic competition and trading rules such as NAFTA.

- *Helping to increase employment rates by creating new job opportunities*, and by doing so reducing fiscal demands on social security, particularly important in aging populations. Broad programs to increase competition create jobs, though heavy costs may be borne by workers who face job losses. There is little doubt that anti-competitive practices destroy jobs. Boskin blames "inflexible, protectionist, highly regulated, and overtaxed" economies for the fact that there were 30 million more working-age people in Western Europe in 1994 than in 1970, but that there were 1 million fewer private-sector workers in Western Europe in 1994 than in 1970.[8] In the United States, long-run employment levels have increased in most reformed sectors, and employment has been reallocated to more efficient firms within the sectors. Employment growth was spurred by rapid expansion of output to meet the higher demand generated by the results of regulatory reform: lower prices, better customer service and increased product diversity. In many countries, however, positive employment effects of market liberalization will be limited without further reforms to social security systems, labor market reforms, and active measures to upskill the workforce.

- *Maintaining and increasing high levels of regulatory protections* in areas such as health and safety, the environment, and consumer interests by introducing more flexible and efficient regulatory and non-regulatory instruments, such as market approaches. Use of tradable permits in the United States to reduce sulfur dioxide emissions by 10 million tons annually, for example, reduced emissions ahead of schedule, while reducing costs by an estimated $1 billion. The Netherlands Kyoto target (6 per cent reduction of greenhouse gas emissions from 1990 levels over 2008-2012) is ambitious, but a green certificates programme for renewables, a transparent market-based mechanism, promises to be a highly cost-effective means of reaching the target. Many countries are adopting international standards that, while delivering high levels of protection, are also trade friendly.

Only some countries in some sectors have, however, enjoyed these gains. Telecommunications and financial services, driven by globalization and technological opportunities, are reform leaders in most countries, while important domestic sectors such as transport, energy, construction, land use, distribution, professional services, and health care lag behind. Social policy areas, except for environmental protection, have barely been touched. Recent OECD work has shown that, despite several years of intense regulatory reform, the friendliness of regulatory environments to product market competition still varies substantially

8. Boskin, Michael (1999), "Capitalism and its Discontents: The Adam Smith Address," Hoover Institution, Stanford University, No. 96, p. 9.

across OECD countries (Figure 1 classifies economic and administrative regulations into two areas: inward-oriented and outward-oriented policies, depending on whether regulations are directed at domestic or foreign operators).[9] The United Kingdom, Ireland, the United States and New Zealand seem to have the least restrictive overall regulatory environments, while the regulatory environment appears to be the most unfriendly to competition in Italy, Greece and Norway. A massive and politically difficult task of pushing forward with first generation reforms lies ahead in OECD and non-OECD countries alike.

Even if reform goes as planned, difficulties in OECD countries should not be glossed over. Concerns about costs to workers in restructuring sectors, the quality of new jobs in terms of security and benefits, consumer protection, environmental quality, and distributional effects related to the mobility of resources are legitimate and should be answered with concrete steps to ensure that reform does not threaten important public policy goals. The challenges are even greater in countries where the core rules needed to underpin market functioning -- such as property rights, judicial institutions, commercial codes, and bankruptcy laws -- are not in place. Failure to provide an institutional and regulatory environment where restructuring and investment can occur reversed the gains of privatisation in some CIS countries.[10] It was helpful that these institutions were already in place in most OECD countries and did not have to be built. As this suggests, the results of reform are sensitive to local conditions, and hence lessons learned in any one country must be carefully considered for relevance to other countries.

Finally, first-generation reforms operate in an environment of policy complexity and disorder that increases unpredictability and risks. Macroeconomic disruptions have delayed and masked the impacts of structural reforms in many countries. The multidisciplinary and multi-sectoral characteristic of optimal reform places it in the category of reforms that national governments find hardest to do well, since structurally they themselves tend to be fragmented and rigid. Regulatory structures are changing quickly in some areas, yet are rigid in others. Change tends to be episodic, incremental, and reactive, shaped by shifting political opportunities. Old and new institutions and instruments are layered, with little attention to the efficient, co-ordinated, and democratic functioning of policy systems as a whole.

For those reasons, we should not be complacent about the gains, difficulties, risks and costs of the first generation of reforms. The quality and timing of reform will differ from country to country. Policy mistakes and reform delays at the national level will occur and will be costly. Global trends leave room for reversals and divergences at the national level. We often see the phenomenon of "ever-ending" reform, in which crisis stimulates reform (as entrenched interests lose power to resist change), but an easing of the crisis allows countries to avoid addressing the roots of the problem, setting the stage for a new and more virulent crisis later. Japan provides a classic case of missed opportunities for microeconomic reform through the 1980s and early 1990s, for which it is paying dearly.

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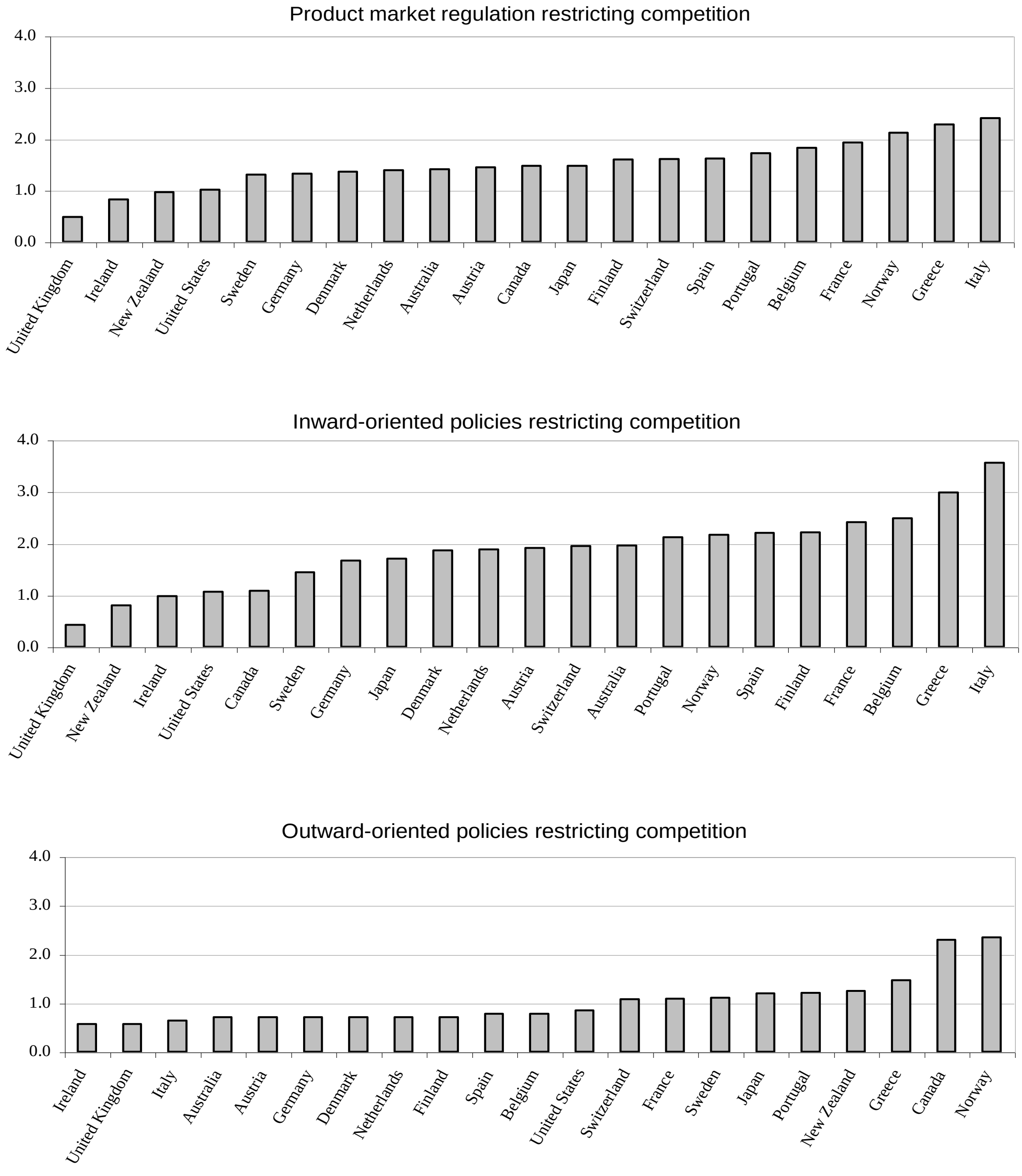
9. The OECD recently established an international regulation database using the responses of Member countries to an ad hoc questionnaire and other sources. The database spans economy-wide and sector-specific laws, regulations and administrative procedures of OECD countries in the 1997-1998 period (sectoral coverage includes retail distribution, road freight, railway transportation, air passenger transportation and telecommunications). The information in the database was used to construct cross-country (cardinal) indicators of (a) the overall regulatory environment in the product market; (b) the policy stance in broad regulatory areas (e.g. state control or barriers to entrepreneurship); and (c) specific features of the regulatory regimes (e.g. price controls) (see Nicoletti, G., S. Scarpetta and O. Boylaud (1999) "Summary indicators of product market regulation and employment protection legislation for the purpose of international comparisons", *OECD Economics Department Working Paper*, forthcoming. For more details on the database and the indicators please contact giuseppe.nicoletti@oecd.org (tel. 331-45248730).
10. Commander, Simon John *et al*. (1999), "Restructuring in Transition Economies: Ownership, Competition, and Regulation," World Bank ABCDE Conference Paper, April.

… and market opening will likely continue for several decades.

Recently, in response to the turbulent events of the past two years, many have asked whether we are on the threshold of retreat from the extraordinary opportunities that a global marketplace made possible by competition, trade, and investment can provide for OECD and the developing world alike. John Nellis recently detected "a multifaceted spirit of 'revisionism' in the air" about privatization.[11] Are public ownership, protectionism, and anti-competitive regulation coming back?

Figure 1. **Overall regulatory approaches from least to most restrictive**



Source: OECD (see footnote 9)

11. Nellis, John (1999), "Time to rethink privatisation in transition economies?" International Finance Corporation Discussion Paper Number 38, p. 3.

The risk of widespread reversal seems remote. Barring a genuinely global economic crisis, markets will continue to expand. The reform process, loosely termed "deregulation", "structural adjustment", or "market liberalization", will likely continue for another 30-40 years in successive waves before the global transformation is largely completed in most sectors in most countries. By then, market-oriented policies will become a normal part of how our governments operate, and market-led growth will have become routine, embedded into new social, economic, and political relationships. There are few signs of reversal. Even the market-oriented reforms in East Asia were accelerated, not reversed, by the financial crisis of 1997, though the pattern is uneven among countries.

But opposition to reform is strong, and political will is not constant. How will reform be sustained? The answer is that there is a powerful logic to market reform that drives an expanding process. One reform exposes other problems, heightens pressures, and leads to further reform. For example:

- Market disciplines are becoming internationalized, formalized and institutionalized. The authorities, institutions, and scope of competition policy are being strengthened in most OECD countries as a counter-weight to sectoral interests. An expanding set of international rules of the game is improving transparency and expectations that are in turn intensifying competitive pressures throughout economies. The experience of Mexico in using international obligations to harden commitments to reform is not unusual. Trade agreements in Japan, OECD membership by Korea, and the European Single Market Program for EU members have all reduced the capacity of domestic opposition to block and delay reform. In some cases, the new market disciplines are geared to producer interests, but in most cases they represent a new concern for consumer welfare.

- Reforms in one area change the sustainability of other policies. The European Single Market opened borders to products, capital and labor, and the resulting competition and need for flexibility are driving a slow reformation of the European welfare state. This process is being accelerated by the introduction of the single currency. Even deep-seated national models are adjusting. The Netherlands, as its economy is integrated into regional and global markets, is evolving from a corporatist to a regulatory relationship with markets. Likewise, changes in one policy change the political economy in other areas. Tariff reforms in Australia in the 1970s and 1980 led directly to structural reforms behind the borders in the 1990s as domestic producers fought to stay competitive.

- Upstream and downstream effects are powerful, so reform cannot be quarantined to one part of the economy. Telecommunications reform in the United States touched off a process of knowledge-based innovation throughout the economy whose results are still unfolding, and that is driving more intense competition. Transport and telecom reforms allowed user firms to compete over greater distances.

- Capital is increasingly seen as a private rather than a public commodity. Financial market reform in Japan, Korea, and other countries is forcing more emphasis on return on capital, and so restructuring has begun in earnest. This is true worldwide. Financial sector reforms, often combined with corporate governance reforms, are at the core of the marketization of many economies.

- Reform changes relationships and creates new expectations on the demand side. More diverse consumer interests demand more choice and more quality, at lower prices. Consumers today do not accept that they should get these benefits in hamburgers but not in public services or utilities such as transport, communications, energy, and health care.

Despite what is probably the irreversibility of expanding markets, we should avoid the impression that we are on an uncontrolled train rushing madly through the night. Intelligent engineers can influence itineraries, sequence trips, and moderate speeds that make the trip more pleasant and less dangerous. That brings us to the second generation of reforms.

Box 1. **Regulatory reform in four OECD countries**

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.

But market-led growth is straining the capacities of institutions. Second generation reforms are needed to re-align relations between state, market, and civil society.

The network of institutions and social interactions between markets, the state, and civil society establishes the capacities of a society to use its resources optimally. The “fit” between decision-makers, institutional constraints, and changing opportunities determines the gap between potential and actual welfare. Yet various institutions and social expectations change at different speeds, particularly when there is a mix of exogenous and endogenous forces, as when global markets interact with domestic policies. For example, indicators produced by the OECD show that outward-oriented policies are now relatively liberal and homogeneous, while domestic policies remain more anti-competitive and heterogeneous.[12]

Second generation reforms are those that align relationships between the state, the market, and civil society to reduce the gap in potential welfare. These kinds of reforms are needed to sustain and consolidate the move to market-led growth, which is evolving so rapidly that it is straining the capacities of lagging or obsolete institutions to perform important functions such as providing security, repairing market failures, and maintaining democratic legitimacy within the policy structure. In other words, the central problem to be addressed by second-generation reforms is *variable institutional adaptation*.

Second generation reforms are more than a response to the fact that weak markets and institutions reduce gains from privatization and market opening. There are three main arguments for why market liberalization should be accompanied by a comprehensive approach to creating more optimal relationships between the state, market, and civil society.

First, governments have learned, sometimes the hard way, that deregulation and market liberalization are insufficient concepts to guide the reforms needed to establish sustainable market-led growth, much less to maximize social welfare. Benefits have often been less than expected, while costs have been higher than necessary. Deregulation understood as *laissez faire* was always a myth, and a dangerous myth when it resulted in under-institutionalization and regulatory gaps that misled or crippled markets and harmed consumers. Current discussions of governance reflect the need to move beyond the ideologies of the “small state” that often underlie deregulation policies toward a more positive and pro-active view of the state in cooperation with civil society. This is not the same debate that occurred in the early 1990s about “governing markets,”[13] which was triggered by active state interventions in the fast-growing East Asian tigers (though it may learn from those experiences), but a different debate about essential complementarities between the state, market, and civil society. In the current debate, the quantity of the state becomes less important than its quality.[14]

The success of deregulation and market liberalization to date is due largely to the fact that they have been quietly reinforced by second generation reforms such as “re-regulation” and “institution building” that depend on positive state action, and other forms of social cooperation such as implicit norms of behavior, consumer activism and trade unionism. These reforms reduce the costs of imperfect markets, though they risk increasing the costs of imperfect government. The lesson being learned is that good governance, backed up by supportive civic institutions, boosts the performance of markets. It is time to

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12. Nicoletti G., et. al.
13. For example, Wade, Robert (1990), *Governing Markets: Economic Theory and the Role of Government Intervention in the East Asia Economies*. Princeton University Press, and World Bank (1993) *The East Asian Miracle: Economic Growth and Public Policy*, Washington, D.C.
14. 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.

assess and systematize those quiet reforms of regulatory governance so that they can be refined into good practices.

Second, the sustainability and coherence of reform depends on its acceptance by citizens. Citizens tend to mistrust market institutions, though today they may not trust public institutions more. Concrete and credible steps are needed to demonstrate to citizens that important public interests such as safety and equity will be safeguarded within dynamic and global markets. These steps can engender public confidence that, in turn, reduces political constraints and the risks of excessive regulation, and speeds up, deepens, and sustains market reforms. Lack of trust is a major cause of over-regulation. When effective, efficient government action improves trust in markets and states, it contributes to the performance of both. A strategic and inherently political approach is necessary, since building public confidence may require trade-offs in short-term and long-term benefits and costs.

The third reason is that changes to the market-state relationship are much deeper and more profound than can be explained by examining the market alone. This helps explain why there is, as yet, no coherent concept of the role of the state in a period of global market-led growth. Structural reform is part of the ongoing evolution of governance and relations between states and markets in capitalist democracies. The issues driving reform today are not largely technical issues of efficiency, but far more fundamental issues about changing relations in society. In the countries reviewed by the OECD to date, the policy debate about regulatory reform implies an examination of the role and shape of the state, the citizen, and the market in modern society:

- In Japan, the goals of regulatory reform "are to complete the move from a model of state-led growth to a model of market-led growth characterized by a more efficient and flexible economy in which the role of government is diminished…. The government has described such a society as one in which personal choice and initiative increase, consumer interests take higher priority, structural change is driven by market pressures, and domestic markets are more open to international competition." The OECD concluded that traditional doctrines of the state-market relationship in Japan had "left regulatory interventions fragmented, incoherent, and vulnerable to a host of special interests."[15]

- In Mexico and Spain, we found that an extraordinary and unprecedented overhaul of laws - 90 per cent of Mexican laws were abolished or revised in six years - had profoundly changed roles of the state in economic development that went back decades or even centuries. In both countries, the ripple effects from these policy and legal changes are only beginning to change attitudes, values, and institutions.

State, market, and civil society are systems for mediating the interests of society. For example, much reform consists of struggles by "outsiders" to gain the status of "insiders" and by "insiders" to protect their territory. Structural reform can be seen as a map of changing interests and relations in society, and the various incentives of those involved helps explain why institutions adapt at different speeds. From this perspective, regulatory reform is not primarily a technical problem of getting regulations right -- it is a task of underpinning new relations in society by building new capacities and institutions, or, more likely, adjusting existing institutions (for example, Japan's system of lifetime employment in large corporations,[16] corporatism in the Netherlands, concessions in Mexico, municipal service provision in Denmark, and perhaps Korea's *chaebol*). When institutions embody cultural values, the process is not so much structural adjustment as it is cultural adjustment, which implies a longer-term view.

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15. OECD (1999), *Regulatory Reform in Japan*, p. 12.
16. Fukuyama, Francis (1999), "Asian values in the wake of the crisis," Paper presented at World Bank conference on "Values, Governance, and Development," Seoul, 26-27 February.

Second-generation regulatory reforms can contribute to a longer-term, comprehensive alignment of state, market, and civil society.

The OECD has arrived at conclusions similar to those being discussed within the World Bank, that is, structural reforms should be based on a longer-term, holistic approach to problems, rather than focussing on incremental changes to individual sectors and policy decisions. Essential complementarities between institutions, policies, and instruments in specific national contexts should be better understood to design reforms in which supportive institutions are aligned. While this seems sensible, it vastly complicates reform, and is hard for governments (and international institutions) to do.

The challenges in better aligning relations between the state, market, and civil society extend far beyond regulatory institutions and instruments, but much can be gained through second-generation regulatory reforms. Allocation of roles is the most basic decision, and it is widely understood today that, where a supportive legal and institutional framework exists, the market process is better than the state at gathering and providing information to individual economic operators, as well as signaling the existence of unexploited opportunities.[17] There is, however, less agreement today than at any time in the past 50 years about the roles and comparative strengths of the state and civil society in improving social welfare. Indian Foreign Minister Singh recently claimed that the debate over the role of the state is over: the state is to support the creative, entrepreneurial capacities of the people.[18] This formulation suggests how closely the roles of the state and the market now coincide.

In the rest of this paper, I examine five second generation reforms that both open up new areas for analysis, and require re-examination of current concepts of desirable reform:

1. *New or adapted regulatory institutions supported by civil society are required to maximize the potential benefits of vigorous market competition.*
2. *The state must find ways to effectively protect other collective interests through better institutions and policy tools, market incentives, and cooperation with civil society.*
3. *The state must become flexible enough to avoid exchanging one set of rigidities for a more advanced set of rigidities.*
4. *To avoid new moral hazard problems, the state must find ways to credibly commit to policies consistent with market-led growth.*
5. *Democratic legitimacy and the rule of law must be visibly sustained as institutions change.*

1. New or adapted regulatory institutions supported by civil society are required to maximize the potential benefits of vigorous market competition.

What new or strengthened regulatory institutions will increase the social welfare potential of market-led growth? Some economists have stressed the role of institutions in economic growth since the 1980s, but this key question gained popular currency only in the last few years, because it is based on a fundamental conceptual shift from a negative to a positive view of the role of the state. Stiglitz has posed the crucial second question implied by the first: given the risks of government failure, are there ways of designing such institutions to enhance the likelihood that public interventions are welfare-enhancing?[19]

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17. Saba, Paolo (1999), "The Role of Competition Policy in Economic Development," OECD, Paper delivered at the 4th International Training Program on Competition Law and Policy, Seoul, Korea.
18. Pre-UNCTAD X Seminar on the Role of Competition Policy for Development in Globalizing World Markets Geneva, Switzerland, 14-15 June 1999.
19. Stiglitz, Joseph (1998), "Redefining the role of the state: What should it do? How should it do it? And how should these decisions be made?" Speech presented on the 10th anniversary of MITI Research Institute, 17 March, Tokyo.

The areas where the OECD has found recurring weaknesses in its Member countries are concentrated on institutional functions that cut across the whole of the economy, that is, that transcend individual sectors. These are competition, consumer protection and corporate governance institutions, market and administrative transparency, and conflict resolution. At the sectoral level, independent regulators are a major advance, but more attention is needed to their design if they are to continue to deliver benefits. This is not to suggest that there are institutional models. The nature of institutions differs from country to country along dimensions such as public/private, formal/informal, and centralized/decentralized. Results are the only common standard.

At the core of the new institutional regime are ***competition, consumer, and corporate governance institutions***. The first generation of regulatory reforms created in some sectors new competition problems, and in others expanded the scope for market abuses. Privatization of state monopolies often created dominant private firms. In many sectors, deregulation attracted substantial entry, followed by consolidation and concentration. This did not necessarily reduce contestability,[20] but effective competition institutions and strong legal tools have proven essential in the aftermath of reform to guard against undue concentration over many years of restructuring.

Competition policy is the principal component of the economic "constitution" that should regulate new market relationships. More than that, competition principles provide an enduring framework for state actions throughout its functions. Abandoning concepts of "fair competition" that open the door to many forms of state intervention, OECD countries are moving today toward a basically economic conception of competition policy. This conception does not prescribe a *laissez faire* "struggle for survival," but encourages rivalry while preventing private firms from engaging in collusion or monopoly at the expense of the public. Strong and effective competition institutions are being built in most OECD countries -- of particular note is the effectiveness of those institutions in Korea, Hungary, and Mexico today.

But competition principles will not penetrate very deeply if they are the responsibility only of a watchdog institution, that is, if new institutions are not matched by adjustments to existing institutions. In most countries, this has not yet occurred. OECD countries maintain large numbers of special industry rules, sectoral regulators and exemptions, which constrain application of basic competition laws. To support consistent state/market relations across the economy, competition principles should be built into the legislative fabric of regulatory regimes. Policies pursued through regulation should be conceived as promoting competition, rather than substituting for it, as much as possible. For example, the mission statement for the US agency that regulates energy requires it "to foster and assure competition among parties engaged in the supply of energy and fuels." The OECD recommended to the Japanese government that mandates of sectoral ministries should include the responsibility to support competition principles and enforcement, replacing open-ended mandates to "promote public interests." Markets and civil society also have roles. Market self-policing can be strengthened through expansion of rights of private action and stronger consumer watchdogs, backed up by more activist and educated judiciaries.

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20. The significance of trends in airlines in the United States, for example, has been hotly debated. Overall, competition has increased under reform, especially on major routes, and prices have dropped dramatically. Morrison and Winston ("The Economic Effects of Airline Deregulation," The Brookings Institution, Washington, DC, 1996) note that 90 per cent of the realignment of relative prices of different routes reflects differences in underlying costs of serving those routes. But there has been significant retrenchment on smaller routes and around hubs where there is a dominant carrier. In these cases, monopolistic pricing has raised prices by an estimated 2 to 27 per cent, sometimes substantially reversing the initial price declines (Grimm, Curtis and Robert J. Windle (1998) "Regulation and Deregulation in Surface Freight, Airlines and Telecommunications," Chapter 2 in Peoples, James, ed. (1998) *Regulatory Reform and Labour Markets*, Kluwer Academic Publishers, London).

Debate on the right level of regulatory protection in markets, such as consumer rights in health care, continues to be intense in OECD countries, demonstrating that attention to consumer protection is important in parallel with economic deregulation. As consumers have struggled with expanding choice in areas such as health care, telecommunications, and financial services, regulators and competitive markets have tried to respond with better information, new standards for quality, and new definitions of consumer rights. The use of information to preserve consumer choice and performance standards to promote innovation is slowly eroding the traditional reliance on detailed technical product standards, as evidenced by the move in 1985 to the "New Approach" in European standard-setting. Yet these efforts are hobbled by weak consumer awareness and lack of organisation in many countries, and neglect in installing consumer protection regimes that work well in new market conditions. In some countries, abuses against consumers have caused backlashes against reform itself. The balance is still evolving, but earlier attention to consumer issues in new markets would have been beneficial in maximising the consumer benefits of reform.

The role of corporate governance in improving the efficient allocation of capital in global markets is increasingly important for long-term development and stable economic growth. Good corporate governance, on which the World Bank and the OECD have joined forces, requires a set of complementary institutions: self-regulation by the private sector, driven by powerful market incentives to comply with good international practices in transparency, must be coupled with establishment by the state of an overall institutional and legal framework. Empowered by disclosure standards, civic institutions such as shareholders, citizen watchdogs and worker groups can participate in upholding standards of corporate conduct. These institutions are in various states of development in OECD countries. The OECD principles[21] recognise that no one model can work well in differing national situations, but they stress the importance of fairness, transparency, and accountability in whatever model is used.

Transparency is largely a question of institutional relations. The OECD recommends improvements to transparency in regulatory decisions and applications because it helps to cure many of the reasons for regulatory failures - capture and bias toward concentrated benefits, inadequate information in the public sector, rigidity, market uncertainty and inability to understand policy risk, and lack of accountability. Moreover, transparency helps create a virtuous circle - consumers trust competition more because special interests have less power to manipulate government and markets. Transparency is also rightfully considered to be the sharpest sword in the war against corruption. Regulators must work to establish a climate of confidence, in which suspicions of abuses and bribery are avoided.

Yet the term is famously nontransparent in operation.[22] In its largest sense, transparency can be understood only in terms of the relationships between state, market, and society, which is to say the organization of how the state projects its power. Among all the structural reforms now underway, an increase in transparency is likely to be the most fundamental and far-reaching in changing relationships. A simple story suggests why. Japan adopted its first Administrative Procedure Act in 1994. The next year, an elderly man who had been repeatedly denied permission to install an extra tank at his gas station was turned down again without explanation. He went to the regulators, demanded to know why, and learned that all along it had been a minor problem that he corrected. As he explained later, "For the first time in my life, I felt equal to a bureaucrat." That quiet change in relationships has revolutionary implications.

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21. OECD (1999), *OECD Principles of Corporate Governance*, Paris. The principles were endorsed by ministers at an OECD Council meeting at ministerial level on 26-27 May 1999.

22. To some, transparency means that the state does what it says it will do, a basic principle of the rule of law. To others, it means that all regulated entities have equal access to regulatory processes, and equally understand their rights and obligations. Transparency can also mean that stakeholders play a role in setting policies that affect them. To yet others, it means that the state is neutral between market players, or that policy results are known and accountable. All are facets of a larger issue.

As this example suggests, transparency often requires more regulation of the private sector, not less. Minimum rules on transparency for financial firms in the private sector (in parallel with more transparency of government economic policies and disclosure of its economic data) will enhance international financial stability. Regulation increases as governments replace corporatist with regulatory relationships, and as governments try to establish transparent conditions for efficient transfer of goods and services across borders. Consumers faced with more choices require more information and confidence building measures. Reductions in informal guidance may lead to more formal regulations.

Other transparency problems found in OECD countries relate to the operations of the state itself. The OECD Public Management Service has documented 13 concrete aspects of regulatory transparency -- ranging from simple notification to the public that regulatory decisions have been taken, to controls on administrative discretion and corruption, to broader organization of the legal system through codification and central registration, to the use of public consultation and regulatory impact analysis. Its indicators of transparency show that countries vary widely, and more importantly, that all countries fall far short of what we consider good practice. The most common areas for improvement include:

- *Establishing new relations with market players through new instruments and structured communications* that reduce rather than increase the risk of capture. For example, the OECD found that, in Mexico, concessions had been a costly, opaque and overly discretionary way to regulate the network and natural resources industries. We recommended that other market entrants be permitted to comment on concession changes for dominant firms, and that many concessions be transformed into permits and licenses or replaced with other regulatory alternatives.
- *Improving due process and administrative certainty*. A key to controlling excessive administrative discretion is the lowly administrative procedure law. Many OECD countries are now adopting or amending administrative procedure laws to improve the orderliness of administrative decision-making and to define the rights of citizens more clearly. In some countries, such as Italy and Spain, the silence-is-consent or tacit authorisation rule switches the burden of action entirely: if administrators fail to act within time limits, the citizen is automatically granted approval. Japan used its new 1994 administrative procedure law to attack the problem of administrative guidance by forbidding the use of coercive guidance and establishing transparency standards for voluntary guidance. In the United States, the cornerstone of the regulatory system is the 1946 Administrative Procedure Act, which established a legal right for citizens to participate in rulemaking activities of the government on the principle of open access to all. Reforms to the Mexican Federal Law of Administrative Procedures in 1996 established a broad framework of principles for regulatory quality. A series of amendments to the 1958 Administrative Procedure Law was the platform in Spain to increase accountability and transparency across the public administration, that is, to move away from the authoritarian traditions of the Franco regime to new relations between government and citizens. The powers of the Spanish central government organisation were redefined to separate the political from the administrative levels throughout the administration. The importance of these kinds of reforms for improving certainty and reducing regulatory risk in the market, while enhancing democratic accountability, can hardly be over-estimated.
- *Correcting inadequate control of regulatory powers delegated to non-governmental bodies*. The importance of non-governmental bodies in regulating -- public corporations and trade associations in Japan, standards-setting bodies in the United States, producer boards in Netherlands, self-regulatory bodies in all countries - is poorly understood. A complex of semi-public and private bodies shares regulatory powers with the government. The quality of their work seems to depend on their relation to competition principles, and their methods of work, that is to say, transparency. Second-generation regulatory reform does not mean unleashing these bodies through a misplaced faith in self-regulation -- it means, rather, a new transparency and competition regime that retains their flexibility and expertise, while strengthening their incentives to work in the consumer interest.

- *Opening markets to international market players*. Foreign firms, individuals, and investors seeking access to a market must have adequate information on new or revised regulations so they can base decisions on accurate assessments of potential costs, risks, and market opportunities. Yet they face disproportionate problems in accessing information. Hence, transparency is one of the six "efficient regulation principles" developed by the OECD to assess market openness.[23]

One of the most highly regarded institutions of modern regulatory governance is the ***independent regulatory body***, heavily used in utility sectors with network characteristics such as energy and telecoms, and in other sectors where sector-specific prudential oversight is needed such as financial services. Dozens of these bodies have been set up in OECD countries in the last few years alone. This trend is fueled by WTO agreements, by reforms in Europe from the Single Market, and by policy advice by the OECD, the World Bank, the IMF, and other international institutions.

The reasons for setting up these bodies -- to shield market interventions from political interference and to improve transparency, stability, and expertise -- are well known. There is little doubt that, compared to regulatory functions embedded in line ministries without clear mandates for consumer welfare, the independent regulators are a sound improvement. It is telling that the market impacts of market-opening have been greatest in precisely those sectors -- financial services and telecommunications -- where independent regulators are most prevalent, though the causality is not clear. But independent regulators have not resolved many serious regulatory failures, and they have created new potential problems that have not been adequately assessed. It is not too early to begin a critical assessment of the performance of independent regulators to determine if improved design can avoid future problems:

- *Independent regulators can reduce political will for real reform* if governments believe that an independent regulator can substitute for structural change in privatized monopolies. A regulator is not a substitute for getting the structure right from the very beginning.

- *The risk of costly institutional rigidities increases as regulators proliferate*. Independent regulators should be seen as transitional bodies that disappear when the competition authority can take over regulation of the sector, that is, when the regulatory issues become general competition issues and technical standards rather than sector specific economic issues. Regulators should evolve as competition emerges - focussing on network issues than on asymmetrical regulation, for example. The risk is that regulators, whether independent or ministerial, will regulate too much for too long, and so hamper rather than aid the development of competition.

- *Sector-specific regulators can slow the larger adjustment of the sector*, and lose potential gains to economic growth and consumer welfare. Traditional sectors are changing and merging with other sectors or new sectors as technologies change, yet regulators are often designed around obsolete ideas of the sector. In these cases, regulators can inhibit sectoral convergence, and consumers lose potentially huge benefits. A hidden cost of a proliferation of regulators is the difficulty of taking coordinated reforms to exploit synergies. Hence, the benefits of comprehensive and multi-sectoral reforms can be lost.

- *The risk of capture can be high*. Sector-specific independent regulators are vulnerable to capture by the very industry they regulate, because regulators depend on the industry for information and cooperation

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23. The six OECD efficient regulation principles for market openness are 1) transparency and openness of decision-making; 2) non-discrimination; 3) avoidance of unnecessary trade restrictiveness; 4) use of internationally harmonised measures; 5) recognition of equivalence of other countries' regulatory measures; 6) application of competition principles.

in order to do their job. The risk of capture does not seem to materially change when regulation is moved from line ministries to independent bodies.

- *Fragmented competition policy will distort economic development*. The relationship with the competition authority is often confused when sectoral regulators are responsible for dealing with classical competition problems, such as exclusionary practices or mergers, under their own statutes rather than under the competition law. The result is fragmentation of competition principles across the economy. This has produced conflict and confusion in some sectors in some countries. The OECD is firmly of the view that a single, economy-wide framework of sound competition policy principles should be applied equally everywhere.

- *Independence can create governance problems with democratic accountability*. Good regulation is not just about finding the right technical solution, but about placing that solution within a larger policy, economic, and social environment in which it can function. The term "independent" is unfortunate, since no regulatory agency is truly independent from the governing system. If independence is poorly designed, the regulator can seem nonaccountable, and outside of essential controls of the democratic system. Majone has argued that a mix of approaches is necessary: "[A] highly complex and specialized activity like regulation can be monitored and kept politically accountable only by a combination of control instruments: legislative and executive oversight, strict procedural requirements, public participation, and, most importantly, substantive judicial review."[24] Regulation in Europe, he says, does not live up to these standards. In OECD countries generally, these dimensions have been neglected.

The efficiency and certainty of ***conflict resolution*** can dramatically change risk assessments in the market. As decisions in terms of resource allocation and economic success and failure are shifted to producers and consumers, they must have efficient and low-cost ways to resolve disputes. This is true both for private disputes and for disputes about government decisions. Conflict mediation institutions are working poorly in many countries. Judiciary and public sector appeals procedures are often too slow, too nontransparent, and too uncertain to establish a good environment for market confidence and entry.

2. The state must find ways to effectively protect other collective interests through better institutions and policy tools, market incentives, and cooperation with civil society.

The state is not withering away in the face of markets. If anything, the average size of the state 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. But despite its continuing control over resources, the state is perceived to be losing effectiveness in the face of pressing economic, social, and environmental problems, and economic insecurity.

The central problem may be regulatory in nature. 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). The thrust of first generation reforms was to enhance market capacities, with little attention to state capacities. In second-generation reforms, the test for successful reform should be that it does not erode but, rather, enhances the capacity of societies as a whole to promote public welfare. What does this mean for the state? First, it means that, although regulation will continue to be an important tool for advancing public policies, the state must improve its policy capacities to diagnose problems more precisely, assess alternative solutions, and wield a wider range of more effective and lower cost regulatory approaches and alternative policy

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24. Majone, G. (1993), "Controlling Regulatory Bureaucracies: Lessons from the American Experience," EUI Working Papers in Political and Social Sciences, European University Institute, Florence, Italy.

tools. Second, it means that governments must join forces with market and civil society institutions, that is, co-operation with non-state institutions is needed to meet policy challenges and public demands.

We already see important changes occurring in the nature of regulation. Social policy regulation has risen rapidly at the same time that public ownership and economic regulation have declined. In the 1960s and 1970s, rising demands for government action in areas such as health, safety, housing, labor contracts and working conditions, environment, and consumer protection led to expansion and proliferation of regulation and regulatory institutions. The output was voluminous: in the United States, the volume of federal regulations grew from 9 745 pages in 1950 to more than 100 000 pages by 1980 to over 140 000 pages by 1999, and anecdotes suggest similar growth in other OECD countries. Rapid growth continued during the years of so-called "deregulation" in the 1980s and 1990s; in fact, no form of government activity increased in OECD countries as much as did regulation. Growth will continue, since public demand for these kinds of regulations appears to be intensifying and budget cutting tempts governments to shift costs to the private sector through regulation.

How do we reconcile the perceptions that, on the one hand, the state seems to be losing power to markets, and on the other, it is rapidly increasing regulatory controls? These are not necessarily inconsistent trends. The 1997 *OECD Report on Regulatory Reform* concluded that:

> *...economic regulations have often proven to be extremely costly and ineffective means of achieving public interest goals...In general, public policies such as protection of health, safety, and the environment are better served by using competition-neutral instruments, such as well-targeted social regulations and market incentives, to change behaviour in competitive markets.*

On a very large scale, states are moving from potentially more costly to potentially less costly forms of market intervention. Economic regulation is more likely than public monopoly to produce net benefits, and social regulation is more likely than economic regulation to produce net benefits. Problems, such as monopoly characteristics of networks, traditionally addressed through public ownership are increasingly addressed through less interventionist economic regulations. Problems, such as service quality and distributional issues, traditionally addressed by hidden cross-subsidies enforced through economic regulation, are increasingly handled through competition-neutral social regulation, other policy instruments, or the market, supported by competition and consumer policies.

Seen in that light, the worldwide shift away from ownership and anti-competitive economic regulation toward more neutral styles of social regulation has greatly improved the potential benefits of state action. A better understanding of this trend would be useful in overcoming one of the barriers to market liberalisation by showing how governments can regulate effectively within the paradigm of dynamic and global markets.

Yet potential benefits do not necessarily translate into actual benefits. Social regulation that is competition-neutral and transparent can still be inefficient and costly if policies are misguided or outdated, or regulation is badly designed or applied. Costs and benefits of social policies implemented through regulation can be very high. In the United States, direct costs of social regulation and government formalities are credibly estimated at between 4 and 10 per cent of GDP, though the Office of the President reported that net benefits of social regulations are increasingly positive, due to regulatory controls such as regulatory impact analysis and use of more efficient policy instruments.[25] If social regulations are to achieve public policy goals and produce net benefits, governments must restructure themselves so that they can produce high quality regulation. Government capacity to do this depends very much on the quality of

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25. Office of Management and Budget (1997), *Report to Congress on the Costs and Benefits of Federal Regulations*, September 30.

decision processes and policy tools, backed up by good understanding of market forces and the effects of state intervention. These are core governance issues.

Again, the OECD has seen consensus developing around what constitutes good regulatory practices for social policy. OECD principles for quality regulation adopted by its 29 Member countries state that governments should withdraw from direct regulation of market entry, exit, prices, and normal commercial actions, and should work to improve the cost-efficiency and flexibility of instruments for delivering social policies.[26] Tools for improving the net benefits of social regulations have steadily developed in most OECD countries. They include:

- building regulatory management and reform capacities at the centre of government in order to promote and oversee reform efforts, provide independent checks of regulatory quality, and co-ordinate and integrate related policies. Today, governments in most OECD countries have created dedicated, expert bodies with responsibility for regulatory reform;

- adopting regulatory quality assurance mechanisms such as quality standards, tests for regulatory need and simplicity and written justification for regulatory decisions. Among the most important are adoption of the benefit-cost principle and assessing regulatory costs and benefits through methods of regulatory impact analysis. By 1999, some 24 OECD countries were using various methods of regulatory impact analysis, up from only 2-3 in 1980;

- using a broader array of effective, lower-cost policy instruments such as goal-based regulation, information strategies, and incentives that use competitive markets to advance social goals. This often involves replacing "command and control" regulatory systems -- in which the regulator specifies precisely how firms must meet a regulation -- with incentive-based systems that rely to the extent possible on market forces. Governments are learning to change the “game” for private participants in ways that are welfare enhancing, for example, by creating rents that reward desirable behaviour;[27]

- harmonizing national with international standards and assessing trade impacts;

- reviewing and updating existing regulations through structured processes of rolling reviews, sunsetting, and guillotine methods. Korea completed in mid-1999 the astonishing task of cutting government regulations by 50 per cent in one year, and participants observed that most of the regulations could not be justified as meeting any current public need;

- improving public consultation and access to regulations through procedures to make drafts available to stakeholders, devising more efficient means of maintaining dialogue with the public, and using electronic technologies such as the Internet;

- finding new ways to apply regulations transparently and improve incentives for compliance through establishing registries of regulations and formalities, with positive security and one-stop shopping, and developing compliance-friendly regulations based on better understandings of the practical realities of the regulated entities;

- evaluating regulatory results and correcting mistakes by moving to results-oriented public management in which measurable goals are established and assessment techniques are developed.

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26. See OECD (1997), *The OECD Report on Regulatory Reform* (Paris), and OECD (1995) OECD Recommendation on Improving the Quality of Government Regulation, with the Checklist for Regulatory Quality (Paris). Also available on the OECD website at http://www.oecd.org/puma/regref/.

27. Stiglitz, p. 5.

These tools are proving to be effective remedies to some regulatory failures, but they are only slowly changing national regulatory habits. The search for cost-effective policy tools implies new relations with markets and social interests. The move from service provider to market regulator in areas such as pensions, health, and public utilities, for example, has enlarged the range of players with which the state must cooperate. In other areas, the state is just one player among many seeking to represent and serve the public. National governments must learn to co-ordinate with other centres of power including international and sub-national levels of government, the media, industry, and NGOs to understand and meet public needs.

3. The state must become flexible enough to avoid exchanging one set of rigidities for a more advanced set of rigidities.

How do we avoid changing one set of rigidities for a more advanced set of rigidities? Regulatory rigidities are commonplace in our countries - many countries are just now changing laws and regulations established decades or even centuries ago for very different conditions. Governments have forgotten why many laws exist. In Australia, a housing code that mandated a minimum distance between bathroom and kitchen was based on a short-lived theory dating from the last century that smells carry disease -- yet the regulation was changed only in the 1970s. An eighteenth century ban in the United Kingdom on the sale of game meat except in winter months was intended to prevent poisoning before refrigeration -- and was lifted only in the 1980s. Early retirement for train engineers in France was adopted when engineers had to shovel coal and could not physically perform after a certain age -- and engineers today still strike to maintain the privilege.

Another reason for rigidities is that success breeds failure. It is difficult to see that what worked well 20 years ago is a mistake today. Fast growth that continues for several years creates high risks of crisis later, when the conditions for growth change, because entrenched institutions and interests credibly resist adjustment on the grounds that the "model" has proved successful. Smaller countries are more nimble than larger countries because the cushion for sustaining costly policies is smaller, and they cannot afford the luxury of nostalgia. Larger countries such as France, Germany, and Japan, and the United Kingdom in the 1970s, enjoy substantial savings that can be useful in postponing change, though the cost of change will be larger when the time arrives.

Regulatory rigidities are enormously costly. They slow innovations and force resources into less valuable uses. In Japan, failure to update regulations governing medical devices means that global manufacturers retain old production lines only to supply the Japanese market with lower quality products at higher prices than the rest of the world. Governments commonly underestimate the velocity of change. Countries that respond too slowly in the communications industry simply lose new investment, since the product cycle is 6-8 months. One-half of the products that GE makes did not exist five years ago. In the United States, regulatory reforms unleashed a level of innovation in products, services, production methods, and corporate organization that is responsible for most of the economic gains, and the importance of these effects demonstrates how much the regulatory structure had repressed innovation in many sectors.

The OECD reviews of regulatory reform suggest that regulatory flexibility is more valuable than static regulatory efficiency. That is, regulation that adapts over time to changing conditions contributes more to economic and policy performance than does regulation that is optimally efficient at a point in time. Technological change and globalization will increasingly reward dynamic regulatory efficiency.

But how can flexibility and regulatory adaptation be improved so that policies adjust in the right direction? How can adjustment be initiated and sustained against powerful special interests that benefit from existing practices? Stiglitz reminds us that rigidities can be rooted in processes intended to protect democracy and accountability.[28] The OECD has also seen that decentralisation of regulatory power, intended to improve responsiveness of the state to local needs, has created new rigidities when oversight and accountability mechanisms are weak. Hence, the question is how those values can be maintained while enhancing the capacity for timely policy adjustment.

Many of the reforms now underway will reduce rigidities, such as the move from technical standards to performance standards. But the long-term answer lies in the processes of decision-making. The capacity for change is largely determined by the contestability of regulatory policies, which can at the same time enhance both democracy and flexibility. Contestability is driven by open and transparent processes, multiple actors, and administrative, political and judicial channels for challenge. The emergence of more vibrant multi-party political systems in Mexico and Japan are extremely valuable from this perspective. Open administrative procedures are needed to break down information monopolies inside bureaucracies, and to permit emerging interests to challenge established interests. One would expect that federal countries would have an advantage in flexibility -- because subnational governments act as laboratories of innovation for the entire country -- and this seems to be the case in countries such as the United States, Australia, Mexico, and, to a lesser extent, Germany. In general, however, the larger size of federal countries seems to offset this advantage. More intensive and public scrutiny procedures for existing regulations are needed. In sector after sector, outdated regulations and inefficient regulatory techniques survive deep in the regulatory jungle because there is no accountability for their performance. The current move to results-oriented public management will assist in linking regulations more closely to transparent policy objectives.

4. To avoid new moral hazard problems, the state must find ways to credibly commit to policies consistent with market-led growth.

Efficient resource allocation requires that risks be borne by investors who operate on the basis of risk-adjusted return on capital. Government intervention, even when necessary for other reasons, often creates moral hazard problems by suggesting that governments could be made to share those risks. This is an important problem, because many opportunities for such moral hazards exist from past and current practices of government intervention. In most countries, a moral hazard fog obscures assessment of true investment risks. At its worst, where the fog is thickest, moral hazards can so distort resource allocation that they contribute to macroeconomic crisis. Consider the example of the Korean *chaebol*, which drained away capital from the rest of the economy because they were, accurately for many years, considered “too big to fail” and hence shielded from market discipline.

Governments cannot simply walk away from existing moral hazard problems, since the transition period may be too painful, and it may be unfair to shift risks without compensation. Therefore, we have what I call a growing number of “stranded moral hazards” that are very difficult to face, and that are being used to slow or even block reform.

New moral hazards are emerging. In Denmark, stringent environmental policies have been used to justify massive direct and indirect subsidies for wind power, with the result that Denmark has the largest share of wind electricity in the world. Government support for this technology will distort Danish and regional markets for investments in green generation technologies for many years to come. Reforms driven by macroeconomic turbulence and under the umbrella of restructuring risk creating new moral hazards. In Korea, *chaebol* “self-directed restructuring” was moving too slowly, so by the end of 1998 the government took a more directive role, including agreeing on “Big Deals” or consolidation in key sectors, and restructuring programs. Though the Korean government may need to intervene where the banks are incapable of overseeing successful restructuring, the role of the government must be carefully disciplined

28. Stiglitz, p. 2.

to avoid creating the perception of official approval of the new and perhaps not sustainable enterprises. Such a perception will distort investment and entry in the restructured sectors. In Mexico, the peso crisis of 1994 is still rippling through the economy, and due to bankruptcies, the government has become a reluctant owner of banks and airlines during restructuring. This makes it difficult for potential market entrants to judge regulatory and other policy risks.

Clearing the moral hazard fog will not be done quickly. Moral hazard problems are extremely difficult to resolve because they are embedded in the reputation of governments. Past behavior is for a long time the benchmark for future behavior, and when a crisis appears, markets must guess, "Will they or won't they?" The solution to credibly establishing a regime change lies in implementation of a mixed package of policies: an aggressive competition policy, combined with transparent corporate governance, well constructed exit policies, and extraordinary care in ensuring that investors bear the risks for investments, that is, complete transparency in financial markets.

5. Democratic legitimacy and the rule of law must be visibly sustained as institutions change.

There is much discussion today about how globalization results in "democratic deficits" and the decline of the sovereign state. These debates are rooted in concerns that governments are losing too much power to market players, that regulatory protections are seen as costs and barriers, and that "citizens" are becoming only "consumers". The experience of the OECD with the Multilateral Agreement on Investment -- in which the OECD-brokered agreement failed because of an intense international campaign against what was perceived to be its re-balancing of policies away from public interests and toward the interests of international investors -- is an example of the strength of the concerns, and the need to address them forthrightly.

The diagnosis of the problem is, however, often misleading. It is true that some policy decisions formerly made by states are now made by markets and non-state actors. But the threat to public well being today is not that policy decisions are being internationalized too much; it is that, while the world has become more interdependent in many areas, governments and decision-making patterns have remained firmly embedded in the national-state structure. In the long-term, raising global standards of welfare will depend on how well national governments manage co-operation in an interdependent world.

My own view is that economic and social interdependence has diminished, not the capacities of the state, but only the effectiveness of traditional national institutions and policy tools. Loss of national sovereignty can be countered by strengthening and expanding international relationships so that policy effectiveness is restored or even improved through collective action. Internationalisation of regulation is, for example, a purely practical response for governments facing problems in areas such as environmental quality, crime, immigration, disease prevention, human rights, food safety and provision of basic services such as communications and energy. Regulators have reacted to the threat that global mobility poses by developing new modes of international coordination.[29] When government effectiveness is restored through coordinated action at the international level, this strengthens the credibility of the state and the rule of law.

If the process of building an international dimension into state institutions is to be successful, two issues must be addressed. First, the quality of policy decisions in international institutions can be poor, unaccountable, and nontransparent, though they are improving. International regulatory institutions can also be vulnerable to manipulation by insider interests. John Braithwaite at The Australian National University has written brilliantly on the need to improve global regulatory governance and supervision of

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29. Bratton, William *et al.* (1996), *International Regulatory Competition and Coordination*, Oxford: Clarendon Press, p. 2.

international institutions, including such proposals as strengthening parliamentary and NGO oversight of international regulatory activities.[30]

Second, the role of the national legislature urgently needs rethinking. Democracy is a process rooted in precise national institutions and relationships. These democratic elements are slower to change than markets and civil societies, and in fact even public administrations are changing more quickly than legislative bodies. Where law is replaced by spontaneous market organization, legislatures are replaced by investors. Where technical complexity requires a high degree of expertise, legislatures are replaced by technocratic elites in the public administration or other institutions. The Conference of Speakers of the European Union Parliaments is currently conducting an important debate on the changing roles of parliament in an era of globalization. A statement adopted by the Conference notes that, since Parliaments are the bodies that represent society as a whole and that mediate conflicts, "Parliaments are the institutions with the greatest interest in fostering forms of inter-institutional cooperation."[31] This holds promise, though the forms of parliamentary cooperation are as yet nascent. Creative solutions are needed to prevent democratic parliaments from being sidelined as new international arrangements evolve.

Evolution of the state/market relationship will not be determined by the power of global markets, but by the weaknesses of national states. Policy failures are usually caused by avoidable failures of national governments.[32] Though seemingly harsh, this is an encouraging conclusion, because it suggests that governments do not have to give up the considerable benefits of globalization to effectively serve the interests of their citizens. Rather than being intimidated by global markets, the state should develop the right tools to carry out its legitimate and necessary role. It is striking and heartening that most issues central to this debate appear, in fact, to be largely explained by problems of institutions. Given good will and intelligence, these are correctable problems.[33]

Conclusion: The solutions are found in the basics: market-led growth supported and tempered by civic values and good governance

The evolution, endurance, and creation of institutions in state, market, and society comprise the main focus of second-generation regulatory reforms. Changing state/market relations is not a zero-sum game in which markets expand at the expense of the state. What is happening today is far more complex and positive. The re-construction of essential institutional relationships holds the promise of making all players better at what they do, as comparative advantages are defined over time and roles adjusted accordingly. The international institutions can reduce the risks of mistakes and speed up the learning process by pooling and comparing national experiences.

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30. See Braithwaite, John (1994), "Prospects for win-win international rapprochement of regulation," in OECD, *Regulatory Cupertino for an Interdependent World*, Paris.

31. Conference of Speakers of the European Union Parliaments (1999), "The complexity of legislation and the role of parliaments in the era of globalization," Lisbon, May. p. 9.

32 In fact, the greatest threat to the rule of law in OECD countries today is not global market liberalization, but poor domestic regulatory practices such as incapacity to control regulatory inflation. A steady rise in the volume, quantity, and complexity of regulations has outstripped the capacities of private citizens to understand and comply with rules, and the capacities of the public sector to understand and apply the rules. This has economic impacts: market liberalization is more likely to lead to damaging concentration when regulatory complexity slows or deters market entry. The OECD has written extensively about the dangers of regulatory inflation for the rule of law and the performance of both states and markets. See Scott Jacobs, Rex Deighton-Smith and Rebekka Buchwald; "Regulatory Quality and Public Sector Reform," (1997), The OECD Report on Regulatory Reform: Sectoral and Thematic Studies, OECD (Paris).

33. Jacobs, Scott (1994), "Regulatory Co-operation for an Interdependent World: issues for government," in OECD, *Regulatory Co-operation for an Interdependent World*, Paris.

Addressing the key challenges in the second generation of reform -- building new market institutions, meeting collective interests in dynamic markets, increasing the flexibility and responsiveness of our national governments, reducing the costs of moral hazards, and preserving the effectiveness of the state and the democratic rule of law -- will reduce the risks and costs of the profound changes moving across the globe, partly a consequence of first generation reforms. It is by no means certain that governments will be successful in harnessing these changes. The economic and social energies and ripple effects set into motion through market opening are so vast and complex that it seems beyond the capacities of governments to understand them, let alone influence them. Little wonder that there is fear about market reforms, and legitimate questions put to those of us who promote them.

Yet the solutions to many problems seem to be within our reach. They include strong competition principles, more attention to market transparency and openness, high quality public sectors, and vibrant civil societies -- that is, the basics. Old solutions such as a return to *dirigisme* will not work, and radical new solutions such as global government are not needed. We need to keep working on market-led growth supported and tempered by civic values and good governance.