

WORKSHOP ON GOOD GOVERNANCE FOR DEVELOPMENT INITIATIVE IN ARAB COUNTRIES: Managing Risks in Regulatory Reform

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The issue: rewards and risks of reform

Reform has the capacity to deliver great benefits in key areas of the economy and society:

- a more competitive product market environment for a stronger productivity performance and stronger trend growth
- more efficient infrastructures (electricity, telecoms, rail/road/air transport) for attracting foreign investment and developing local and regional markets
- more efficient public services (health, education, social welfare services) for a better quality of life

Reform also means change and change is not without risk, even if it promises great rewards. How should change be managed so as to minimise risk? In the broadest, most strategic terms, reform risk is about managing the change from one regulatory/governance framework (A) to another (B). Most reform programmes focus on defining the end point B in terms of the starting point A (the “what” of reform), but pay little attention to the process of getting from A to B (the “how” of reform). Awareness of this dynamic element to reform is an important step towards eventual reform success.

Risk factors in reform

- **Incomplete definition of the starting point A.** Are all the relevant factors of the current regulatory/governance framework well understood? Relevant issues can span a broad range: from fiscal systems and state ownership to the current structure of relationships between different parts of government.
- **Incomplete definition of the end point B.** Is there a clear vision of the strategic objective? There may be too many objectives, or the objectives may not be clearly articulated.
- **Different types of risk.** Reform often starts with a relatively simple economic objective at its core: how to make a sector or an economy perform more efficiently. The process of economic change may, however, carry non economic risks- to health and safety, security of supply, social welfare, equitable regional development, or environmental objectives.

- **Not all eventualities can be predicted.** This is partly because reform is often “learning by doing”. The broader consequences of a specific reform cannot always be predicted in advance. For example contracting out public services may ease fiscal constraints but poor subsequent performance may then need attention.
- **The long haul of reform.** Effective and durable reform is a long term and dynamic process, not a one off event that can be quickly brought to a close.
- **Opposition to reform.** Reform often involves change directed at improving resource allocation in the economy. This involves taking away rents and/or acquired rights. Real and effective reform, as opposed to redistribution, involves reducing these rents. In the long run, economic performance improves and everyone benefits. But the beneficiaries from rent reduction are less sharply aware of the benefits, which tend to be dynamic and long term, than the losers of their losses.
- **Changes in responsibilities.** It is important to keep track of who is responsible for what. Pre reform responsibilities are often centralized and reasonably clear. The change to more dynamic and market oriented frameworks tends to disperse responsibilities in some sectors such as the infrastructure sectors. There is also a need to maintain the right balance between central control and delegated responsibility.
- **Inappropriate rules for a new market/governance framework.** Rules that work under one framework are unlikely to be so effective under another.
- **Technology.** Some sectors such as telecoms are changing rapidly and regulatory frameworks need to keep up. More broadly, the rapid spread of new media for communication needs to be taken account in communicating reform and in its implementation (and in the use that reform opponents may make of new media).
- **Specific risks tied to particular sectors.** Systemic risk (the impact of a failure in one part of the value chain on the operational performance of other parts of the value chain) is one example. Normally associated with banking, it can also be said to exist in the electricity and some other network sectors.

Managing reform risk

(1) Policies and strategies

- **Communication.** Enthusiasm (with supporting evidence such as quantified benefits of reform). Reassurance (it will be OK). Frankness (it may take time). A communication plan is a good idea, with explanations suited to different audiences (technical stakeholders but also the wider public). Regulatory Impact Analysis (RIA) can help to promote transparency, clarity of communication, and the engagement of relevant stakeholders, as well as a more coherent view of the different elements of reform.
- **Reform strategy.** A clear and comprehensive strategy that sets a vision of the end point B and identifies the essentials for getting there.

- **Reform sequencing.** There are limits to what a country or society can absorb at any one time. This includes social aspects such as subsidized pricing of services: perhaps subsidies need to be unwound slowly (but surely). There are also practical considerations of what comes first. Structural separation should probably come before competition in infrastructure sectors with a natural monopoly core.
- **Building advocates for reform.** Building these up, for example via *ad hoc* task forces to spread ownership and help communication. Business is often a natural ally of reform (though beware vested interests). Consumers can also lend their voice.
- **Defusing opponents of reform.** Addressing vested interests. Addressing losers. Losers can be sectoral (eg infrastructure sectors) or areas or regions (subsidized for public services in the past). The failure to undertake substantial and visible action to compensate perceived losers from reform may undermine reform and even provoke a reform backlash. An active and honest approach is better than pretending the problem does not exist.
- **Using external levers for reform.** Market openness and membership of a regional grouping are tested factors of success in economic reform.
- **Ensuring (if at all possible) early results in visible areas.** This helps to sustain enthusiasm for ongoing reform and helps reform to acquire its own positive momentum.

(2) Capacities and institutions

- **Identifying, making use of, and possibly setting up well functioning institutions that can help move the reform process forward.** This could be the national audit office, competition authority or any other part of the government infrastructure that has the capacity and willingness to help. If appropriate (it may not be) a new institution (central unit) can help to coordinate, monitor, and encourage the reform process. There are many examples of such units and their effectiveness. Another strategy is to build up a web of pro reform institutions, some new and some existing. Reform needs many “champions”. Spreading ownership of reform across as large a number of stakeholders as possible ensures that reform champions emerge who will outlast the demise of any particular individual or group. Business and consumers are very effective general targets for this.
- **Using the competition authority.** Competition authorities in particular have an excellent track record in helping change in many countries.
- **Supportive finance ministries.** Many if not most reforms have a financial dimension, for example driven by a budget crisis or fiscal constraints. Finance ministries can be very important in lending weight to reform, and can play a valuable advocacy role within government.
- **Managing the different levels of government.** Reform needs to percolate down through all levels of government. Reform at the centre of government will be undermined if it is not picked up by other levels.

- **An adaptable bureaucracy.** Civil servants play a pivotal role in reform. They may feel threatened by it as they need to develop new capacities such as adaptability. The process of culture change takes time but can be reinforced in many different ways (incentives, performance pay, new contracts, training, opening some posts to outsiders).
- **Consultation and feedback.** It is important to ensure that those at the “coal face” of implementing specific changes are directly involved, so that they can comment on feasibility and risks.
- **International regulatory clubs and exchanges.** This includes sharing information on regulatory developments and experiments, keeping up with best practice and joining regulatory clubs.

(3) Tools and rules

- **Targets, controls and evaluation.** There is a need to set measurable targets, but at least as important, a need to keep track of them. Strong monitoring and evaluation processes need to be built in from the start, backed by incentives to meet the targets. It helps to keep players on track, and publicizing the results helps to sustain reform momentum.
- **Enforcement and compliance.** This starts with the design of rules that are likely to generate good compliance. RIA and consultation can help with this. It also means ensuring that enforcement powers are adequate. Caution needs to be exercised with self regulation and voluntary reliability standards, which can be misused.
- **Defining new rules for new market and governance frameworks.** Beware of deregulation. In many (not all) areas the objective is to change the rules, not remove them entirely. This applies especially to the infrastructure sectors.
- **Clearing out obstructive rules.** This means rules that are inappropriate or even positively unhelpful.
- **Allocating responsibilities clearly under new market and governance frameworks.** Responsibilities for control, monitoring, security etc need to be clearly allocated between government and market players, or between different parts of government.
- **Tools for specific purposes.** An important example are the tools that have been developed to manage markets which continue to include a mix of public and private enterprises: competitive neutrality frameworks, corporate governance frameworks, fiscal unbundling.
- **Carrots and sticks (rewards and punishments).** These may take the shape of fiscal incentives, for example between levels of government.
- **Devices to lock in the reform process.** This may be a public (and well publicized) agreement which includes clear benchmarks for progress.