Four fundamental limitations

Incentives drive behavior. I believed in this completely and as a result, for a while, both my children grew up with an elaborate incentives framework. It was indeed a short-lived experiment because I found it extremely hard to tailor incentives for my teens.

And so it is no surprise that the era of using incentives for regulation of economic infrastructure seems to be up for a major revision. The process started five years ago. In his last book, *Regulation and Development*, one of the world's best regulation specialists, Jean Jacques Laffont presented four limitations of the theory of regulation when applied to infrastructure in developing countries.

Limited capacity is about inability of country's policy makers to implement policy due to a variety of reasons: lack of financial and human resources available to regulators or even capacity to audit costs that would lead to excessive returns to regulated firms.

Limited commitment by government often creates renegotiations of contracts. There is a widespread belief that institutional weakness makes it impossible for the firms to rely on contracts thus increasing risks regarding prices or demand conditions. Lack of commitment leads to adverse selection in the bidding process and the firms selected are often those who think they have the best chance of success in renegotiations rather than most efficient ones.

Limited fiscal efficiency arises from inefficient tax administration and high cost of public funds. Both these factors limit fiscal space available to government to distribute gains from sector regulations widely across different income groups or support public investments.

Limited accountability is the final institutional failure which leads to collusion and regulator capture. Often government agents are also not the benevolent social maximizers and the media is full of stories of economic rents and corruption linked to infrastructure projects.

Almost all infrastructure problems, be that lack of universal access, high cost of services, poor quality, or wide spread corruption can be traced to these four limitations. Laffont did suggest possible alternative structures, but the world is quite far from a relevant theory of regulation that can mitigate the daily problems faced by infrastructure policy makers.

Why do I bring these four limitations to the forefront today? First, to remind ourselves and academicians that even though five years have passed since the release of this book, we still do not have a workable theory of incentives and regulation of economic infrastructure in developing countries. Second, efforts to overhaul financial sector regulation comprehensively are ongoing but no such efforts are in sight for infrastructure. Surely, there is a need for greater debate. Third, developing countries are investing billions to improve infrastructure and the existing blueprints of regulatory structures borrowed from the developed countries are not delivering. Manila's water tariffs have gone up four times instead of the promised 50% reduction by water regulator. India's power costs are set to rise with one and half percent increase in base rate and additional incentive bonus of half percent for keeping the schedule. How many other industries are assured of 16% rate of return by regulators?

Posted by Rita Nangia on 24 October 2010