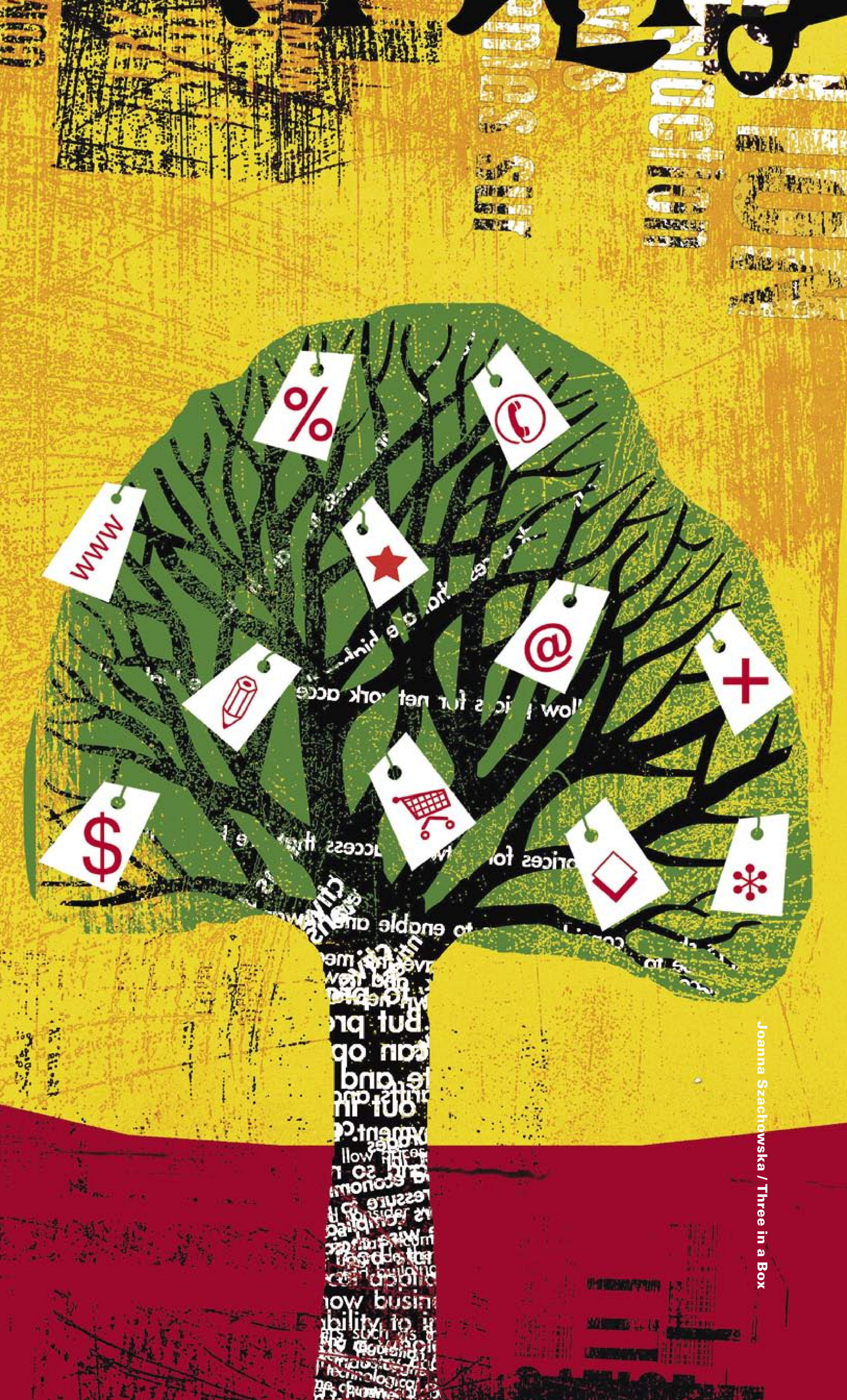


Joanna Szachowska / Three in a Box

Regulation that's good for competition

Unfortunately, regulation often has a negative effect. What can governments do to get it right?

**Scott C. Beardsley
and Diana Farrell**

The aim of economic regulation should be the same in all sectors: to facilitate fair competition among players or, where natural monopolies exist, to ensure fair pricing and service levels. Greater competition means stronger productivity growth, which in turn means a faster-growing economy and more wealth to share. Yet governments everywhere struggle to get regulation right.

Why regulate at all? First, market economies can't function properly without rules: property rights (including trademarks and patents that protect innovators) underpin transactions, and antitrust laws safeguard fair competition. The painful transition away from Communism in the former Soviet Union is a particularly vivid example of the need for a basic legal framework. Second, regulation is necessary to mitigate broader market failures in generally competitive industries—for example, to protect consumers from abusive practices, to introduce and maintain safety standards, to protect vulnerable workers, and to control environmental pollution. Moreover, some forms of regulation (such as orphan-drug rules for rare diseases) aim to force or encourage businesses to meet the vital needs of unprofitable customers. Third, regulatory intervention is vital in supporting competition and so promoting the welfare of consumers in their dealings with electricity, telecommunications, and other network industries that tend to monopoly because of huge infrastructure requirements.

Article at a glance

Economic regulation should facilitate fair competition while mitigating the impact of market failures.

Despite good intentions, regulation often has negative consequences. Rules to guarantee good minimum wages, for instance, often limit the creation of jobs for low-skilled workers.

A fact-based approach and a transparent process are essential for optimal regulatory decisions. So is controlling special-interest groups.

Regulation should protect people rather than jobs, let the market pick winning companies and technologies, and take account of the infrastructure needs of nations—and of the differences among them.

Regulation often runs into substantial difficulties, however. For starters, there is no manual for implementing market-supporting regulations. When regulators define rules of competition in areas such as predatory pricing and intellectual property, they must constantly strike a tricky balance. Rules and standards to protect consumers must be sufficient, but not so costly as to discourage innovation and halt progress. Governments are too inclined to frame policy through trial and error, confusing economic goals with political and social ones. Although such experiments often reflect genuine choices about the type of market competition a society wishes to have, pressure from special interests for state intervention may not be benign and may completely undermine the economic rationale for regulation. Thus governments sometimes—and often unintentionally—devise rules that hamper competition and create long-term drags on growth.

The McKinsey Global Institute (MGI) believes that poor regulation is the main factor limiting productivity and growth in economies throughout the world, particularly developing ones. India, for example, could raise its labor productivity by 61 percentage points if it removed harmful rules. Brazil could raise its labor productivity by 43 percentage points (Exhibit 1). MGI research on Russia suggests that more effective regulation in that country, principally to ensure fair competition, could raise its structural economic growth rate to as much as 8 percent a year without significant capital investment, which it now struggles to raise despite current high oil prices.

In a recent study of 145 countries, the World Bank[1] found that the administrative cost of complying with regulations is three times higher for businesses in poor countries than for those in rich ones. Yet businesses in poor countries have less than half the protection for property rights. Heavy regulation and weak property rights, moreover, exclude the poor from business. Women, young, and low-skilled workers suffer most.

[1] International Finance Corporation and World Bank, *Doing Business in 2005: Removing Obstacles to Growth*, Oxford University Press, September 2005; and World Bank, *World Development Report 2005: A Better Investment Climate for Everyone*, Oxford University Press, September 2004.

Companies in both developing and developed economies are worried. A CEO survey presented at the 2005 World Economic Forum, in Davos, identified overregulation as the most important threat facing businesses. How can governments craft more effective and balanced regulations? MGI studies of 17 economies, as well as McKinsey's long and deep experience working with regulators and businesses, have helped us identify three common regulatory traps and some basic principles to help rule makers avoid them.

Inappropriate regulation of factors of production

Governments sometimes restrict competition in a wide range of sectors by inappropriately regulating markets for factors of production, such as labor and property. They try to prevent abuses and correct market failures, but their efforts frequently have unintended consequences.

Costly labor market regulations

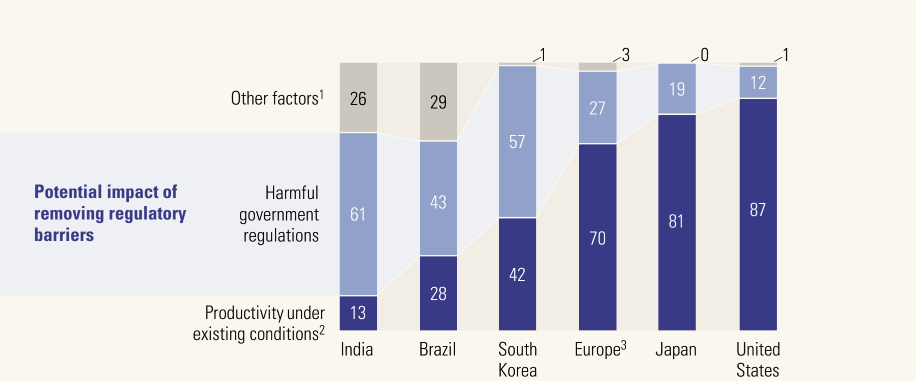
Perversely, regulations that protect jobs often constrain employment. Managers who have only a limited ability to reduce the workforce in a downturn are hesitant to hire new workers. This reluctance makes it harder for competitive companies to grow.

Furthermore, regulations guaranteeing decent wages for the most poorly paid workers often limit the creation of new low-skill jobs in service industries. France, for instance, sets its minimum wage at a level twice that of the United States. As a result, US retailers employ 50 percent more people

EXHIBIT 1

The regulation straitjacket

Productivity; index: best practice = 100



[1] Includes infrastructure, other structural elements of economy.
[2] India, 2001; Brazil and South Korea, 1998; Europe, 1997–98 (France and Germany, 1997, United Kingdom, 1998); Japan and United States, 2000.
[3] France, Germany, United Kingdom.

per capita than do their French counterparts. Although not plum jobs, these do boost the economy's overall ability to create wealth while helping many low-skilled employees avoid social exclusion and giving them an opportunity to move up the income ladder. Instead of raising the minimum wage, with its possibly damaging secondary effects, governments can provide assistance to low-income workers by using earned-income tax credits to reduce their taxes.

Restrictive land and property regulations

Regulating land and property can slow growth by inhibiting capital investment and industrial consolidation. Japan's zoning laws, for example, protect mom-and-pop retail shops but prevent the expansion of more productive large-scale discounters. Small shops account for more than 50 percent of the Japanese retailing sector, compared with less than a quarter in the United States.

Unclear land titles and property rights also stifle growth. In the Philippines, as Hernando de Soto shows in *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*,[2] it can take 13 to 25 years and almost 170 steps and signatures to acquire a piece of land legally. As a result, 60 to 70 percent of the country's people don't have legal title to their land. This problem not only precludes the development of a mortgage market and, hence, of a robust financial system but also removes the main source of collateral for small-business owners and entrepreneurs. It is also hard for bigger companies to obtain enough land.

Overregulation of competitive sectors

In most countries that MGI has studied, the biggest constraints on economic growth result from inappropriate and unevenly enforced regulations in naturally competitive manufacturing and service sectors, such as consumer goods and construction.

Protectionist market entry regulations

To protect local industry and employment, governments create barriers such as import tariffs and restrictions on foreign direct investment. But protection of this kind insulates local companies from competition and so removes their incentive to provide better and cheaper goods and services, thereby harming the broader economy.

In India, for example, a small-scale-reservation law designates hundreds of products that only companies below a certain size may manufacture. It also restricts investments in fixed assets by companies that produce most of their

[2] New York: Basic Books, 2000.

output for the domestic market. Both domestic and foreign manufacturers therefore can't reach economies of scale.

Restrictive product market regulations

Governments rightly create safety standards to ensure that electrical appliances are not a fire hazard and food standards to protect the people's health. But some product market regulations make it harder for companies to innovate and become more productive. In the long run, consumers and the whole economy lose out.

Japan's regulations governing the materials and techniques used in home construction, for example, aim to preserve the national character of the country's building stock. They work: every house in Japan looks different from other houses and is uniquely Japanese. But the construction industry can't raise its productivity through standardization, which would make housing cheaper. It would be better if consumers could decide for themselves whether to pay an aesthetic premium.

Germany restricts the hours when retail stores can be open in order to protect their workers and to make Sundays special. But these regulations, combined with high minimum wages and with zoning laws limiting hypermarkets, have helped keep the productivity of German retailing 15 percent below that of retailing in the United States.

Inflexible regulation of former monopoly industries

When governments liberalize utilities, railroads, and other network industries, the potential productivity gains are enormous. Utilities usually account for 10 percent or more of a nation's GDP, and their prices affect the performance of companies throughout the economy.

To create competition in sectors such as telephony and electricity, regulators often try to lessen the market power of incumbent former monopolists. One common approach involves requiring them to let new retailers use their networks at a favorable wholesale price while still insisting that they provide universal coverage for profitable and unprofitable customers alike. Competition is vibrant in such former monopoly industries of most developed economies. The transfer of profits away from the incumbents has been substantial, and prices have tumbled in some sectors: from 1990 to 2002, for example, the cost of fixed-line telephone calls fell by almost 50 percent in the countries of the Organisation for Economic Co-operation and Development (Exhibit 2, on the next page). The granting of licenses to a host of new mobile-telephony operators has also increased competition and demand, improved the infrastructure, and cut prices.

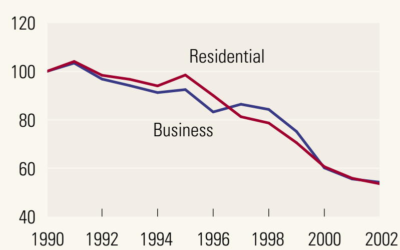
Governments, however, often struggle to create flexible frameworks that anticipate and respond to conditions as markets evolve. In telecommunications, for example, regulators in developed markets are struggling to take account of new technologies that, along with existing regulations, are changing the balance of power between incumbents and attackers. Although alternative platforms such as cable, wireless, and VoIP (Voice over Internet Protocol) are substitutes for traditional fixed-line telephony, they tend to be regulated separately and, in some cases, circumvent regulation altogether.

As a result, the challengers are gradually eroding fixed-line telephony, which still generally accounts for a majority of the revenues and profits of the incumbents. Under current cost structures, if such regulatory asymmetries are not adjusted to reflect the new reality they will severely reduce the returns of the incumbents' fixed-line business. That will in turn undermine the incumbents' ability to invest in new infrastructures and technologies (such as a national broadband network) that would benefit consumers and the overall economy in the long term.

EXHIBIT 2

Plummeting

Fixed-line call charges[1] in member countries of Organisation for Economic Co-operation and Development (OECD); index: 1990 = 100



[1]Domestic calls only; excludes fixed-to-mobile and international calls, monthly line rental.

Source: OECD; Telegen UK; McKinsey analysis

Getting regulation right

Regulators should keep certain guidelines in mind as they tackle the difficult task of making their rules more effective.

Make regulation fact based and transparent

A fact-based approach and a transparent process are the keys to making optimal regulatory decisions and controlling special-interest groups. Regulators should understand not only how different options will affect the economics of competition in a sector but also their social and political implications. Detailed modeling and analysis are required to clarify the trade-offs and to judge whether the goals of regulation will be met.

Some governments that formerly failed to undertake this kind of analysis are now changing their ways. Until now, for example, India's government has banned foreign direct investment in the retail sector in the belief that modern formats favor the rich and that greater competition wouldn't drive substantial growth elsewhere in the economy. But having undertaken a

>>> The incentives developing countries use to attract foreign investment—and the restrictions placed on it—are often ineffective. See "The truth about foreign direct investment in emerging markets" (www.mckinseyquarterly.com/links/17287).

microeconomic analysis showing that modern-format discounters offer lower prices and that a competitive retail sector would generate productivity growth in one-third of the total economy, the government may lift the ban.

Making regulatory barriers more transparent—for example, by measuring levels of regulation against international benchmarks—helps a country develop a community of support for regulatory reform and therefore puts pressure on the special interests behind the status quo. A community of this kind often includes academics, international organizations (such as the World Bank and the Asian Development Bank), the global media, influential private foundations, private individuals, and, of course, representatives of the one group likely to benefit most: consumers.

Make regulation dynamic

Dynamic rule making is particularly important in heavily regulated sectors. A regulator should continually assess not only the kinds of rules each of them requires but also, if competition is already established, whether fewer rules might make sense. Like taxes, regulations are hard to remove or reduce, but doing so may be necessary to stimulate growth and innovation.

Regulators can make rules more malleable by adopting a "sunset" clause that requires regular reviews of how well regulations fulfill their purpose and either extends their sunset dates or automatically terminates them at a particular time. The US Civil Aeronautics Board Sunset Act of 1984, for example, ended nearly 40 years of close regulation of airline routes and fares by the CAB. This move led to intense competition and to lower prices that helped consumers and the US economy at large.

Today many regulatory laws are also subject to impact assessments: system-atic examinations of the advantages and disadvantages of ways to achieve an objective. Most OECD countries have adopted this approach, but they don't use it to the same extent, and many developing countries don't use it at all. Some governments have also established independent consultative bodies, such as the United Kingdom's Better Regulation Task Force.

Regulate factor markets with care

Reforming the rules covering the factors of production can have a major impact. Because of the complex and sensitive trade-offs between economic and social objectives, however, reform must be handled with great care if it is both to win broad support and create economic value.

Spain achieved both goals in the 1990s, when it introduced more flexible labor laws that helped cut unemployment by 40 percent in only six years. Among other things, the reforms let employers and employees negotiate contracts (rather than having labor laws dictate the terms) and created a new type of permanent contract, which reduced the employers' payouts to laid-off workers by 60 percent, for youths and other groups that have unusual difficulty finding jobs.

Belgium, by contrast, maintains generous early-retirement schemes intended to promote corporate restructuring and to keep the peace with labor. But they have generated huge costs for the government and given the country one of Europe's lowest employment rates. Only one in four Belgians aged 55 to 64 works.[3]

Let the market pick the winners

Regulations governing competitive markets should be neutral in their impact on different players. Leveling the field for new entrants, whether at home or abroad, spurs competition by pressing incumbents to match or surpass their productivity. When governments take this perspective, they avoid the regulatory trap of trying to protect enterprises of every scale, from mom-and-pop stores to national airlines.

Regulators clearly have a role in developing national technological standards. But with rare exceptions, they should avoid favoring one product or technology over another, since doing so often reduces incentives to compete and innovate. Europe's decision to deploy the Global System for Mobile Communications (GSM) and to allow roaming and interoperability across borders was effective because these moves helped mobile technology to penetrate European markets more quickly than it did elsewhere. But European telecom ministries had previously urged (and sometimes forced) operators to buy telecom equipment made in the home country—a decision that drove costs much higher than they would otherwise have been.

Enforce regulations evenly

Allowing some players to gain advantage by disregarding the rules also distorts competition. When regulators fail to tackle the gray (informal) economy, in which companies underreport employment, avoid paying taxes,

[3] *Prospero: A New Momentum to Economic Prosperity in Belgium* (2004) is available at www.mckinsey.com/locations/benelux/work/prospero/index.asp. The work is based on data from established Belgian sources, such as the Federal Planning Bureau, the National Bank of Belgium, and the National Institute of Statistics; from international organizations, including the European Commission and the Organisation for Economic Co-operation and Development (OECD); and from discussions with union leaders, politicians, academics, and top executives at Belgium's private and public institutions.

and ignore product quality and safety regulations, the market can't pick the winning products and services. Companies operating partially or wholly outside the law gain substantial cost advantages, which more than offset their low productivity and small scale and help them stay in business. Larger, more productive, and law-abiding companies therefore can't gain market share—a huge problem in low-income nations, where the informal economy generates an estimated 40 percent of GNP. It is widespread in some developed nations too.[4]

To address the problem, governments must devote enough resources to pay for adequate enforcement of tax and other regulations. Many developing countries in particular will have to improve their tax collection and audit capabilities and to increase penalties for those flouting the law. To avoid massive social repercussions in the transitional stage and to increase the chances of success, governments should address the informal economy one sector at a time.

Protect people, not jobs

When regulators try to save employment in a particular sector, they may succeed for a period, but at the expense of job creation elsewhere in the economy. In the United States, for example, anxiety about losing service jobs to offshore providers is widespread. But MGI research indicates that the US economy as a whole gains sizable benefits from offshoring, through corporate savings, additional exports, repatriated profits, and greater productivity.

Rather than seeking to prevent the loss of jobs eliminated through the search for higher productivity, regulators should focus on cushioning the blow for workers who become unemployed and on easing their transition to new jobs. Such assistance could include retraining programs and company-sponsored insurance to offset lower wages. From 1979 to 1999, however, 69 percent of the US workers who lost their jobs through the offshoring of services found new work within six months, and roughly half moved to higher-value-added activities.[5]

In many Western European countries, regulators should also facilitate the creation of new jobs by making labor and product market rules more flexible so that they don't stifle competition and innovation.

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[4] Diana Farrell, "The hidden dangers of the informal economy," *The McKinsey Quarterly*, 2004 Number 3, pp. 26–37 (www.mckinseyquarterly.com/links/17280).

[5] Lori G. Kletzer, *Job Loss from Imports: Measuring the Costs*, Institute for International Economics, Washington, DC, September 2001 (www.iie.com).

Don't regulate business processes

In naturally competitive and liberalized sectors, businesses should be free to decide how best to meet any standards for the health and safety of their products and for protecting the environment. If governments use restrictive regulations to control the operations, organizational structure, and practices of companies—including the way they satisfy their demand for labor—their ability to innovate in pursuit of greater productivity will suffer.

Consider the 1990 US Clean Air Act amendments, which established a "cap-and-trade" system to reduce sulfur dioxide emissions from coal-powered electricity plants. By setting a cap while giving companies the option of trading their rights, regulators encouraged utilities to explore innovative ways of reducing emissions. Companies had an incentive to cut their emissions costs to levels below the market price for the rights and to sell their excess rights to other companies. The scheme achieved its targets more cheaply than expected: experts predicted that the cost of reducing sulfur dioxide emissions would range from $700 to $1,500 a ton, but the final market price of the rights reflected a cost of only $350.

Tailor regulation to national markets

Regulation must reflect the legal and institutional background of specific countries as well as their stage of economic and infrastructure development; copying foreign regulations is rarely appropriate and can be downright harmful. Although benchmarks help to increase transparency, they must be comparable. Factors such as the cost of capital, labor rates, population density, demand patterns, the competitiveness of the industrial structure, and the stage of liberalization vary widely by country. Benchmarks should thus be tailored to the local environment, since they can drive very different regulatory outcomes.

Many developed economies that moved quickly to privatize telecommunications were acting logically when they based their regulatory regimes on the role of the fixed-line incumbents that then dominated the industry. But in some developing countries (including the Czech Republic, Jordan, Malaysia, and Russia), the incumbents' fixed-line networks already have far fewer users than new mobile networks do. In such cases, mobile may be a much more efficient way to provide universal service. It might be appropriate to regulate both kinds of networks in a similar way to ensure the widespread development of a mobile data infrastructure at generally accessible prices.

Remember the need for infrastructure

Rail and telecom networks, water and gas pipelines, and distribution grids are all capital intensive, with long payback periods. Regulators should consider ways to promote and reward investment in these networks. One way might be to let prices for network access be higher than its actual cost so that incumbents can reinvest in or upgrade networks and new players find it worthwhile to build their own. Another possibility is "ring-fencing" new investments by, say, guaranteeing that a new telephony network investment won't be available to other players for a period of time.

Make natural-monopoly trade-offs explicit

Clearly, some cases will involve natural monopolies (or temporary ones in industries such as pharmaceuticals) as well as many types of rail and power infrastructures. Here regulators should make explicit trade-offs between the tight regulation of pricing and the interests of consumers, on the one hand, and the effects of regulation on employment, investments in infrastructures, business models, innovation, quality, universal service, and the like—elements that competition usually drives—on the other. Rural mail, telephony, and rail service, as well as the pricing of orphan drugs for rare diseases, are just a few such questions. The key is to analyze facts and objectives so that their implications become clear and to make explicit trade-offs among the interests of diverse groups of stakeholders. Issues such as cross-subsidies, the protection of intellectual property, and predatory pricing must constantly be evaluated and addressed in these kinds of environments.

Crafting regulations that encourage rather than hinder competition and growth is increasingly tough at a time of accelerating technological change and economic uncertainty. Politicians are under pressure to protect troubled industries and to safeguard jobs. The work of regulators is ever more complex—which makes it ever more vital that they make wise choices.

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