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CAN BETTER REGULATION INCREASE WELFARE AND EMPLOYMENT?

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The topic

Regulatory reform is high on the agenda of most industrial countries. We discuss the reasons of regulation in a market economy and how the understanding of economists have changed on this topic over the past decades. The primary goal of regulatory reform is the increase of economic efficiency which eventually will lead to higher income and welfare. In a medium term perspective and in an economic environment of double digit unemployment rates in many European countries the issue of employment effect become a separate aspect of the problem.

The rational for regulation and its change over time

Economic theory distinguishes three main arguments for regulation in a market system, which are – according to the level of agreement of questioned economists – ranked in the following way:

- **Argument 1: All economists share the view that government should combat market. Competition policy should prevent monopolies, assess mergers, fight monopolistic practices. The legislation should guarantee that firms will innovate by a system of patents; government has to encourage basic research and to help to internalise rewards for innovation activities, as it should internalise external costs in polluting activities. Government should counteract informational asymmetries for example in facilitating credits and guarantees to small and medium sized firms.**

- **Argument 2: Most economists share also that there is some redistributive goal for government, helping the poor and the needy and promoting safety, health and education, however, there is considerable difference as to the extent and to the methods. Most economists maintain that efficiency and distributive issues should be held separately, since otherwise both goals will not be reached and costs would explode.**

- **Argument 3: Disagreement rises if we come to macroeconomic objectives like increasing growth, and stabilising prices and business cycles .**

The scope for intervention today is seen as more limited than before. Market failures have to be large to justify intervention, since each intervention infers administrative costs and can be the source of a policy failure. Secondly the type of intervention recommended changed. Formerly the competition authority had regulated existing firms (by lowering prices or limiting price increases), now it is recommended to facilitate entry. Former natural monopolies are nowadays considered as potentially contestable, e.g. by competition for the market, by unbundling obligations to open of bottleneck facilities (central grips) for the competitors etc. Even in fields in which profits should not be the most important allocation criteria, the role of proper incentives for providing quality and quantity of services are acknowledged (health system, schools, universities).

Methods of regulatory reform are different in nature (see Tichy, 1998, this book). The radical route is the abandoning of existing rules. Such a system is often recommended for entry restrictions, which are thought to be unfair towards newcomers and disadvantageous for innovative services. Since one of the rationales for these rules were informational asymmetries and the prevention of low quality suppliers, the elimination of qualification tests implies that the liability rules should be toughened. Additionally a competition authority has to prevent monopolisation and unfair practices.

In the sector of the former national monopolies we have mentioned already the substitution of monopoly control (low prices, high quantify) by the new instruments, like competition for the market, unbundling, vertical disaggregation etc. In case of bottleneck facilities the competition authority has to guarantee access, cost based access prices and fair rules. Whether old style regulation or new style reregulation needs more intervention capacities is an open question. A specifically delicate task is to prevent international mergers which would substitute old national monopolies by a few new international mega-oligopolies. Similarly intervention may be necessary to preserve diversification: geographically dispersed retail outlets foster welfare, purely commercialised media and books may not be the ultimate goal of a high income/high wealth/high leisure society. The new type of regulation should guarantee minimum consumption of health, education, social contacts, this is discussed as provision of universal services.

Within the administration and in the production of public goods, the definition of objectives, of success criteria and proper incentives for employees and agency as well as consumer signals can be introduced.

Better rules

New Public Sector Management provides regulatory rule which want to infer efficiency and rationality into the public sector, while allowing to reach different goals from those under pure private supply of goods and services. The practice of two decades of reforms, deregulation and reregulation has added specific elements for better rules of government.

Principle rules are to target outcomes and not instruments (first rule), secondly to create performance rather than design based standards and thirdly to accept differences in the objectives of agency and public in general for example by a strict

separation of regulators (principal) and owners and management of the firms (agencies).

Among the *operational rules* the new literature advises to create one stop shops, that means that even if different aspects of a process have to be judged by different agencies, the firm or the person initiating the process should have one main partner, who promotes and accelerates the process. Simple transparent rules, the repeated elimination of unnecessary rules (sunset legislation), a benchmarking procedure whether the same process is regulated in other regions or countries and the prevention of double and triple regulation are other rules sounding as simple as they are often neglected.

On the *organisational level* a deregulation authority is needed as a counterforce to the tendency that each new problem, task, accident calls for more and stricter regulation and that the authorities have a self interest to be on the safe side (of more regulation). Time incentives should work in favour of the applicants, permissions not declined after a certain time are assumed to be granted. The use of telecom facilities should be promoted so that no time is wasted by queuing up or restrictive office working hours. Public sector wages should depend positively on performance and government agencies with declining costs should be allowed to keep some part of the money saved for future outlays and some part for wage premia.

What do we know about the employment effect of better regulation?

Past experiences have shown that enormous changes are possible. Welfare, productivity, innovation and service orientation increased in telecom, in deregulated truck industry and many other sectors. On the other hand we know that prices do not decline as fast as productivity, that new oligopolies emerge and that low quantity demand profits less from price decreases than large consumers and that business tariffs go down more rapidly than those of the consumers. Many of these tendencies

are easy to understand for economists, some are contrary to the regulatory objectives. This is no reason to stop the reforms, but should be considered in the new regulatory rules (or attacked by the tax department).

In the long run the economists believe that efficiency increases will also lead to more employment. In an underemployment equilibrium a better match of supply and demand, more innovative services will limit mismatch unemployment. Economic growth will increase with investment in human capital, innovation and product innovations. International competitiveness of a nation increases with lower costs and higher efficiency. The first impact of some regulatory reforms, however, may be negative. In the telecom sector as well as in railways and in reforms in the public sector the incumbents decrease their employment radically as does the public sector if it enforces incentives and abandons old objectives. Therefor let us look into the probably employment effects of different types of regulatory reforms.

Liberalising entry will probably increase employment. New services will easier come up, some existing ones will be spread across a larger number of providers and employees. New liability laws and a stricter enforcement of competitive legislation may be needed.

Downgrading social and environmental standards may increase employment in the short run, but are negative for the long run goal to increase a welfare function, which includes incomes, social stability and environmental preservation as arguments. And Keynesians will add the detrimental effect of lower incomes of the low income/high consumption groups, Michael Porter will maintain that higher environmental standards increase the competitive edge of an innovative, environmental minded industry in high wage countries.

Liberalising former natural monopolies will increase employment in the long run, by adding services and lower costs in price sensitive user industries. Slim administration will decrease employment in the short run, if the objective of the new administration is service oriented this will eventually foster competitiveness of the competitive sector of the economy.

Without doubt positive for employment is if regulatory reforms help to provide the relevant skills (instead of outdated ones). Broader lines of qualification, apprenticeships and traineeships, recurrent education, sabbaticals, requalification, and in general active measures to combat unemployment instead of passive ones will increase employment.

The same should be true for measures increasing flexibility and mobility. Shifting worktime rules to the firm level, increasing choices between worktime and leisure, between net wage and social benefits should provide a better match of supply and demand. Lowering the barriers for short time and part time work could work in the same direction. German data show that currently a larger part of full time employees want to change to a part time work, as compared to the number of part time employees strifing for full time employment. Here a better match could raise net employment. Finally, we know that employees accept changes of the working rules under two conditions: firstly, if they know the objective of the change, secondly, if they can eventually share the profits of the change and can engage in a lasting contract, which will not be altered at short term.

Restructuring payment schedules in the direction of a flatter increase of life time carriers (lowering seniority), increasing the variable (demand and profit dependent) part, better rules for flexible labour hiring could help to increase employment. Combining a part time pension with part time work and reducing the cost for low income earners temporarily can increase employment (though we have to admit that in some cases costs for the public sector can be rather high).

Decreasing administrative costs by co-ordinating and simplifying rules (e.g. different rules for individual taxes, social security etc.), encouraging spin offs and self employment should increase employment. Several national action plans to increase employment stress the costs of business start: one day registration procedures (F), a single registration form (SF), entrepreneurial courses in curricula (DK), fiscal incentives for the first employee (SP, B), and business angels (A, D) are called for in different plans.

Better regulation can foster employment

Summing up it seems possible that better regulation of product markets, of labour markets as well as a new management of the public sector can help to mitigate the unemployment problem. The road is however difficult and not without obstacles. Some measures which increases employment in the long run, may decrease employment in the short run. The reform needs a firm vision, but many small steps on its way. The reform needs a stable high growth environment, in which innovation and research is encouraged and in which the investments in human capital are increased. Low interest rates, an efficient management of the transition to the EURO and some ability of the government to stabilise employment during short run crisis are necessary complements for such a strategy.

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