

Assessing the distributional effects of regulation in developing countries

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Abstract

The paper examines the effect of regulation on income inequality for 72 developing countries over the 1970–2012 period using General Method of Moment estimation technique. The results show that regulation is positive and significantly related to income inequality. The results indicate that regulation has differential effects in developing countries, with the most detrimental effect in Latin America. After controlling for types of regulation, it emerges that labor and general business regulations have a positive effect, while credit market regulations have no effect on the distribution of income.

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1. Introduction

In the past three decades, the globalization of the world economy has promoted policy models of sustainable economic development based on free-market enterprises. The lack of success of

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the Washington Consensus in many developing countries, however, has led to a need for establishing the incentive and regulatory framework which would provide the enabling environment for market forces to thrive. Further, the recent global financial crisis is contributing to a new dynamism in international political economy toward more transparency and regulation of the world economic system. In this paper, we define regulation as the set of laws, decrees, rules, practices or government formalities which govern the political, economic, and social domain (Hafeez, 2003). Manthos, Iftekhar, and Pantelis (2013) claim that regulation reflects law and a prerequisite for its effectiveness is that it creates a minimum level of economic and institutional development.

The political economy debate in many countries shows that changes in regulation have different consequences on different groups of people (Calderon & Chong, 2009). Ambec and Sebi (2011) argue that efficiency can be improved under regulated extraction, noting that the open access extraction of natural resources leads to over exploitation. The motivation for this study is based on the assumption that distributional effects drive the competition for resources by various interest groups, which in turn determines the very nature of regulation policy (Joskow & Rose, 1989). Obviously, the question of who benefits and who is burdened by regulation is an important issue especially in the context of developing countries because of its power and wealth effects (Berlemann & Matthes, 2014; Cafaggi & Pistor, 2015; Marshall, 2011).

It is worth mentioning that a few studies (Barone & Cingano, 2011; Jalilian, Kirkpatrick, & David, 2007) have examined the effect of regulation on growth but not much on the regulation–income distribution relationship. This study contributes to the literature in this direction.

Additionally, attempts to reform the governance structures of national, supranational and multi-lateral organizations have made regulation an issue of highest concern. However, the road leading from regulation to improvement in the distribution of income has not been studied in developing countries. Recent studies suggest that less developed countries face different challenges regarding regulatory intervention (Enste, 2010; Forschaach & Oxelheim, 2014). Apparently, identifying which effects prevail is an empirical issue. Accordingly, this study examines how the quality and quantity of regulation relates to distribution of income in developing countries.

Many authors do argue that regulation is subject to political influences and is rarely implemented with the sole purpose of improving economic efficiency (Guasch & Hahn, 1999; Leone & Jackson, 1981; Regens, Seldon, & Elliott, 1997). Consistent with the political theories literature, it can be argued that the type of political system matters in analyzing the effects of regulation. Consequently, this study contributes to the literature by examining whether the opening up of the political space (deepening democracy) in the region is having any influence on the role of regulation. The third contribution is to investigate the different types of regulation (labor, business, credit) and their differential effects as indicated by Honda (2004) in developing countries. Finally, we consider the recent argument about the threshold effects of regulation, the idea that there is an optimal level of regulation beyond which its effect becomes irrelevant or even negative. The study is based on a sample of 72 developing countries over the period 1970–2012 using the system General Method of Moment (GMM) estimation technique. The dynamic analysis is motivated by the hypothesis that the constraints and difficulties public administrators and firms encounter in adjusting to specific regulations have important distributional implications (Leone & Jackson, 1981). The next section presents a brief review of the literature after which the methodology is described. The results are discussed and the policy implications and conclusions given.

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