Book Review

Regulation and Development
Jean-Jacques Laffont


Writing this review is a sad assignment, because the author did not live to see this great book in print. It speaks volumes of the power of J-J Laffont to clarify important issues in microeconomic theory. Here Laffont brings to bear the technical tools of modern economic theory, and particularly those of second-best theory, to bear on major issues in development and transition. The author's untimely passing was a great loss to our profession.

Originating in 2001 as the Federico Caffe Lectures at the University La Sapienza in Rome, this volume’s nine chapters aim to link regulation, that is, how to apply second-best theory to get best possible results, to development, where the regulatory environment is especially daunting. The many challenges typical of developing (and transition) countries are discussed in the first chapter: high marginal cost of public funds, corruption, weakness of rule of law, and a lack of well-functioning political institutions. The next seven chapters each develop one aspect of regulation: rent-seeking and efficiency, privatisation, enforcement, asset pricing, the universal service obligations, design of regulatory institutions, and separation of powers. Each chapter presents a simple but adequate model, combined with empirical work, either case studies or econometric studies, or both. Thus, each chapter is self-contained, illuminating, and accessible. Laffont has taken great pains to wring the intuition out of the models and to make the econometric work as transparent as possible.

To give some flavour of how this works, let me focus on the privatisation chapter. It starts with motivation and literature review; such classics as Shleifer and Vishny (Quarterly Journal of Economics, 1994) and Boycko, Shleifer and Vishny (Economic Journal, 1996) will be familiar to readers of this journal. Now consider a natural monopoly in a two-type model. The monopoly can be either high or low cost; this information is private to it. Either type of monopoly cost exerts effort to reduce cost. The government observes the monopoly’s results, and has at its disposal both transfers of public funds to the monopoly (costly to the public) or extraction of rent from the monopoly (costly to the firm). The government can be either benevolent (maximise social welfare) or nonbenevolent (rent-seeking, corrupt): both cases are worked out. Finally, the government can
inspect the monopoly, to determine whether it has honestly reported results *ex post*; this again is costly.

This two-type set-up is standard in the literature on information economics. Even if it is new to a reader, Laffont lays everything out quite clearly so that the analysis is easy to follow. In the language of principal-agent theory, the principal (the government) provides incentives to the agent (monopoly) so that the two types of monopoly separate themselves by their behaviour. The second-best theory defines those incentives precisely, as well as determining how often the principal inspects the monopoly (in equilibrium audits are random).

All this establishes the baseline: how much the firm is worth as a regulated monopoly. Now consider the implications of privatizing the firm, by a 51% sale of shares. A routine calculation shows the underlying value of the privatised firm. Depending on the nature of the government, one of two things will happen: (1) the government does not privatise – this occurs at the extremes, either with very corrupt government or with very clean government or (2) the government does privatise – this occurs at mid-range corruption levels. Thus, the relationship between privatisation and corruption is non-linear and non-monotonic.

Finally, the chapter takes this non-linear prediction to the data: specifically, a cross-section of 30 African countries for the years 1990–1996, with political risk variables such as corruption obtained from the World Bank. The main empirical result is robust to a wide variety of specifications: corruption enters the decision to privatise non-linearly, in the way predicted by the model. I am willing to bet these results can be replicated on a cross-section of 27 transition countries for the same years.

The same style of analysis works for many other topics of interest to development and transition economists. The combination of model, case studies on Africa, China, and India, and econometric work is both compelling and convincing.

The volume ends with a three-page concluding chapter: the need for more general models, the difficulty of empirical work, and the preliminary nature of policy implications based on existing work. Although one can hardly disagree, it is nevertheless remarkable how much can be done using Laffont’s methods and models. He is sorely missed, but work such as this book will endure.

Roy J Gardner
Indiana University, Bloomington, IN, USA.
E-mail: gardner@indiana.edu