The good, the bad and the ugly: economic perspectives on regulation in Australia*

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Introduction

It is generally accepted that regulation has expanded greatly in developed economies in the post-WWII era — encompassing a much wider sphere of influence over the economy and society generally. In almost any aspect of our economy or society, a piece of paper somewhere will establish some degree of regulatory control. A day in the life of any of us is one in which we are sometimes protected, sometimes intimidated and almost always touched by the hand of regulation.

This regulatory cornucopia is a mixed blessing. On the positive side, regulation serves a vital role in improving social, environmental and economic standards for Australians. At their most fundamental level, laws — merely a form of regulation — define and enforce property rights, which are the basis for economic exchange. There are also other persuasive rationales for regulation based on the failings of the market. Uninhibited markets can produce undesirable outcomes, such as environmental degradation, unnecessary health hazards, excessive prices and 'unfairness'. By shaping incentives and influencing how people behave and interact, regulation can help societies deal with otherwise intractable problems. At their best, regulations create order, preserve norms and provide a basis for stable progress.

Unfortunately, regulations are rarely, if ever, at their best. Indeed, the community is increasingly sceptical about the benefits of some regulations and about the way in which they are designed and delivered. The American humorist, P.J. O'Rourke, captured the current attitude towards regulation when he quipped that the 'mystery of government is not how it works, but how to make it stop'. Early enthusiasts for regulation — often economists — were sanguine about their ability to design regulatory solutions to perceived economic and social problems. But even well-intentioned regulation can bring problems of its own. The costs associated with these have to be balanced against the potential benefits. Moreover, in some cases regulation is not even intended to further the public interest, being tailored to the needs of particular constituencies.

This more 'experienced' perspective has prompted a critical re-assessment of how regulations should be evaluated and made. The Productivity Commission and its predecessors have contributed to the process of regulatory evaluation and re-evaluation in Australia. This paper draws on some of that work, outlining in particular what has been learned about the effects of different regulatory approaches in the past and the implications for doing better in the future. (If the emphasis is on the more 'pathological' aspects of regulation, it is because this provides the greatest insights into necessary changes.)

Administering and complying with regulation is costly

Regulation is not free. Like any other activity, it uses scarce resources that have other uses. Indeed, there are many institutions and large numbers of government personnel whose main function is regulatory.

At the Federal level, government agencies with explicit regulatory functions alone employed around 30 000 staff and spent some $4.5 billion in 2001-02. This ignores other government departments that have regulatory functions, not to mention ministerial councils and inter-governmental bodies (such as the National Transport Commission).

Only partial indicators of the volume of regulation associated with these bodies are available, but they suggest that regulation has generally been increasing. For example, the Attorney General's Department estimates that there are more than 1800 Commonwealth Acts currently in force. Last year around 170 new Commonwealth acts were promulgated. This is comparable to legislative activity during the 1980s and 1990s, but well above that in earlier decades. More tellingly, there has been a steady increase in the average *length* of legislation. Nearly 55,000 pages of it were passed by the Commonwealth Parliament in the 1990s: equivalent to around 30 pages per Act. This was about twice the page count for Acts passed in the 1980s and almost three times that for the 1970s.

Australian government regulatory agencies use substantial resources

	Expenses	*Staff*
	$m	Number
Australian Customs Service	707	4 669
National Occupational Health and Safety Commission	18	119
Australian Communications Authority	52	406
Australian Maritime Safety Authority	72	292
Food Standards Australia New Zealand	14	122
Australian Prudential Regulation Authority	59	407
Australian Quarantine Inspection Service	171	2 251
Australian Securities and Investments Commission	160	1 284
Civil Aviation Safety Authority	107	673
National Industrial Chemicals Notification and Assessment Scheme	4	38
Australian Pesticides and Veterinary Medicines Authority	21	129
Therapeutic Goods Administration[a]	49	400
Australian Tax Office	3 043	19 318
Australian Consumer and Competition Commission	72	478
Australian Broadcasting Authority	18	134
Total	**4 566**	**30 720**

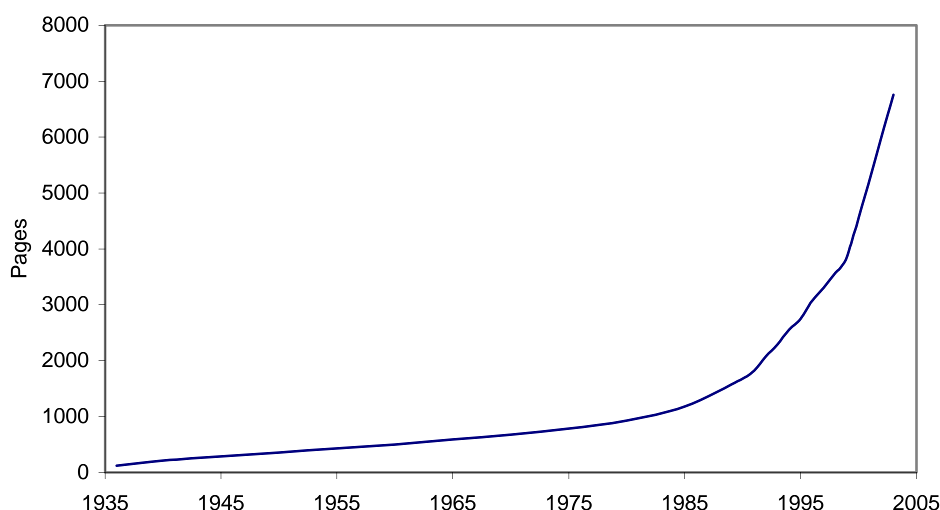
[a] 1998-99 only.

Source: Various agencies' annual reports for 2001-02.

The Income Tax Assessment Act — often taken as a regulatory 'barometer' — has grown particularly rapidly since its inception. At nearly 7,000 pages, the ITAA (the 1936 and 1997 statutes together) is now nearly 60 times longer than the paltry 120 pages that did the job when it was first introduced in 1936 — notwithstanding admirable recent attempts at simplification. To take a fanciful turn, were this rate of growth to continue unabated, I am informed that by the end of this century the paper version of the Tax Act would amount to 830 billion pages; it would take over 3 million years of continuous reading to assimilate and weigh the equivalent of around 20 aircraft carriers!

There is of course a reason for the increasing regulatory detail and complexity — us. Regulations that limit choice or impose costs on people invite evasive responses as much as compliant ones, sometimes more so. Hence the endless quest for tax loopholes (and the commensurate growth of tax consulting services) and the inevitable page-lengthening defensive responses by government. So complexity should not just be seen as something 'done to us' by naïve or incompetent regulators, but as part of a strategic environment.

The phenomenal growth of the Income Tax Assessment Act



Data source: Kobetsky and Dirkis (1997) and recent editions of the ITAA (1936, 1997).

The stock of other less 'visible' types of regulation has also increased over the last couple of decades. Unfortunately there is not (yet) a consolidated and comprehensive register of all subordinate instruments. (This is waiting for passage of the latest version of the Legislative Instruments Bill, first introduced into the Parliament a decade ago.) Available information on the number of statutory rules and disallowable instruments (those subject to parliamentary scrutiny and veto) reveals that more than 7,200 such regulations were made in the five year period

1997-98 to 2001-02. This was about 2,000 less than the total number of regulations made in the previous five year period. But it was still well above the level of regulatory activity in the 1980s.

Thus far, I have only been talking about trends in *Commonwealth* legislation. Regulation by State/Territory and local government often impacts more directly on the activities of firms and the community. Its growth may well be higher than at the Commonwealth level.

Compliance is burdensome

The burgeoning of regulation and its increasing complexity are major irritants for the regulated. According to an OECD survey conducted in the late 1990s, around 80 per cent of Australian firms consider tax compliance burdens have increased, with the main reason being the added complexity of provisions (OECD 2001).

This is compounded by the inaccessible language that characterises much regulation. In a recent conference on regulation, Senator Coonan (2001) cited a delightful example — *The Nuts Unground Other Than Ground Nuts Order*:

> In the Nuts (unground), (other than ground nuts) Order, the expression 'nuts' shall have reference to such nuts, other than ground nuts, as would but for this amending Order not qualify as nuts (unground) (other than ground nuts) by reason of their being nuts (unground).

Popular awareness of the Order — now celebrated as one of the finest examples of obfuscation — is apparently owed to a judge of the Court of Session of Scotland, who sent it to the Guiness Book of World Records (1973).

Frustration with unwieldy regulatory or legal prose is not new. In 1556, the British Lord Chancellor, appalled by the excessive 120 page length of a plaintiff's reply to a defendant's plea, had him fined ten pounds and imprisoned. A hole was made through the document, hung about his neck and he was forced to go from bar to bar (Corkery and Bentley 2001). No such remedies are available today.

Getting a good grasp of the overall magnitude of compliance burdens on business (let alone consumers) is difficult — being plagued by methodological problems and the absence of quality data. Nevertheless, the picture emerging from a range of studies suggests that the costs are large. For example, an assessment by Productivity Commission staff (Lattimore et al. 1998) identified administrative regulatory compliance burdens of around $11 billion on business in 1994-95. Around 85 per cent of this was borne by small and medium-seized enterprises, though they account for a much smaller share of overall employment and activity in the

economy.[1] This reflects the significance of the fixed costs of compliance burdens and explains the particular antipathy felt by many small business owners to regulatory paperwork requirements.

While assessments of this kind sometimes exaggerate identified compliance burdens because of respondent bias, they are likely to *underestimate* the total compliance costs of regulations. For example, regulations not only create paperwork, they can distort decisions about inputs, stifle entrepreneurship and innovation, divert managers from their core business, prolong decision-making and reduce flexibility. To put this in perspective, one American analyst (Hopkins 1996) has suggested that paperwork-related compliance burdens amounted to only around one-third of the aggregate regulatory burden in the USA. Were a similar multiplier to prevail in Australia, aggregate business compliance costs could amount to as much as 7 per cent of GDP.

Of course, these are *gross* costs, neglecting the associated benefits which motivated the regulations in the first place. The collection of taxes is necessary to fund government services on which the community depends, and environmental and other regulations yield benefits to consumers and even some firms. But the point is that the costs of pursuing such benefits are not trifling and that the dividends from better or fewer regulations could be large.

Collateral damage and 'friendly fire': unanticipated effects of regulation

Regulations often have unintended impacts. Sometimes these can actually undermine the goals of the regulator. There are many reasons for this, among which three stand out.

Substitution effects

Regulations explicitly or implicitly alter prices, resulting in demand or supply effects that may frustrate the goals.

On the *demand* side, regulations can fail if they do not take account of how people respond to regulatory-induced price rises. For instance, safety and risk abatement measures tend to drive up the costs and therefore the prices of regulated products and services. These can have perverse effects if consumers substitute into more

[1] A major recent international study (OECD 2001) suggests an even higher compliance burden associated with three major regulatory areas (taxation, employment, environment) of around $17 billion in direct administrative costs in 1998. (See also Banks, 2003)

dangerous alternatives. A well documented US example is the analysis of the costs and benefits of a proposed regulatory requirement for child safety seats on aircraft. In its report to Congress, the Federal Aviation Authority estimated that, while this requirement could potentially save the lives of 5 infants over 10 years, it would be likely to increase *highway* fatalities by 30 to 100 — as a result of families choosing to travel by car rather than by plane as ticket prices rose (Hahn 1997). It is possible, literally, to kill people with good regulatory intentions.

On the *supply* side, a cautionary tale is provided by the case of small-firm access to finance from banks. Prior to financial deregulation, an interest rate cap was imposed as a measure to assist small business. However, the cap made lending to small business less attractive to banks, given the relative risks involved. The result was reduced credit availability for those groups, undermining the goal of the measure. Generally, price ceilings imposed on suppliers who are free to alter supply will have perverse, or at least unexpected, consequences. (A similar story can be told for home loan finance in the post-war period.)

In general, price restrictions of this overt kind are waning. A major exception is the regulation of infrastructure with network or natural monopoly characteristics. Telecommunications, energy, water and other infrastructure services are subject to price regulation, whether de factor or explicit. A number of these regimes have been reviewed by the Productivity Commission in recent years. While the Commission has found that regulation appears warranted, it has signalled a need for greater legislative recognition — both in the application of regulation and the setting of terms and conditions — of the tradeoff between cheap services today and inadequate services tomorrow.

A particular and insidious danger here derives from the often protracted lags between the effects of regulated prices on investment and observed supply (PC 2001b):

- setting prices too low may have little effect on current, sunk asset services, but could deter investment in new or replacement facilities; and
- requiring prices to be the same for all types of demand not only forgoes the benefits of flexible pricing for efficient use of facilities, but also reduces the quantum of funds available for financing investments, again with potentially adverse long-run supply effects.

There needs to be systemic allowance for the fact that getting regulated prices ‘right’ is very hard. This reflects the technical and economic complexity of the infrastructure, the need to compensate investment owners adequately for commercial risks, the changing nature of technologies, costs and demands, and the inherent informational disadvantages of regulators.

While evidence of adverse impacts on past infrastructure investment in Australia has been difficult to verify, the potential risks of adverse consequences from regulatory action appear to be looming larger. Some of these are documented in the Commission's report on the National Access Regime (PC 2001b). The Commission's current inquiry into the Gas Access Regime will allow us to examine the evidence more closely.

An offshore case study that exemplifies the perils of regulatory frameworks paying insufficient attention to *both* the supply and the demand sides is the notorious Californian electricity crisis. It is now clear that this was the outcome of poorly coordinated and applied regulations (not *de*regulation, as some have maintained). Electricity wholesalers were playing 'pig in the middle' — squeezed by price caps at the retail end and high prices charged by generators whose capacity had been constrained by past regulatory initiatives. The financial insecurity of wholesalers eventually led to rolling blackouts and economic dislocation for the state. California has demonstrated that even sophisticated regulators could make errors that cumulatively led to unprecedented regulatory failure. Recent massive (if temporary) disruptions to electricity supply in North America and Europe also give one pause. Can we be sure that it could not happen here?

Overly prescriptive regulation

Regulations are sometimes unduly prescriptive, setting down subsidiary rather than fundamental objectives as requirements, with the result that while the subsidiary requirement is met, the underlying purpose of the regulation may not. A case identified recently by the Productivity Commission concerns that little aussie icon, the platypus.

As is well known, the sale of any of Australia's native animals — even common ones — is prohibited, except on a government-to-government basis, presumably with the laudable objective of protecting our unique native species. Earth Sanctuaries Pty Ltd, a private conservation agency based in South Australia, has somehow managed to generate a surplus of platypuses — indeed, 40 above a sustainable population for the sanctuary. However, it cannot sell any of these platypuses due to the prohibition (offers well in excess of $1 million per animal have been made). In the absence of sales, surplus animals will need to be culled. It is, therefore, also possible to kill *animals* with good regulatory intentions.

Standards for consumer goods often provide detailed specifications about processes or ingredients rather than setting general performance levels, with the potential result that quality products are less accessible to consumers because of added production, delivery and retailing costs. To take an offshore example again, food

standards in the European Union are quite particular about the curvature of cucumbers. Any cucumber with an arc greater than 10 mm per 10 cm of its length, though in all other respects of excellent quality, cannot be described as either an 'Extra' class or class 1 cucumber (Commission Regulation 1677/88). Anyone caught so describing such a cucumber is subject to criminal prosecution. I hasten to add that crooked cucumbers *may* be sold, but only as 'second-rate' cucumbers.[2] Moreover, crooked cucumbers that are too crooked (an arc exceeding 20 mm per 10 cm) must be packed separately from even other second-rate cucumbers. (This curious regulatory fetish is not confined to cucumbers — other fruit and vegetables must meet similar tests. For example, according to Commission Regulation 2257/94, bananas must be free from 'abnormal curvature' of the fingers).

Australia also has many questionable, if less imaginative, standards. For example, government regulation mandates a high definition standard for digital TV (unlike other countries, which have settled for— still high quality — 'standard definition' digital TV). High definition should really be called 'ultra-high' definition, providing cinema quality pictures. Clearly Australian families must have the best. However, it turns out that this cinema quality can only be distinguished on large sets that are extremely expensive, and it requires high cost investments by content providers. The technology is so hungry for bandwidth that — with other aspects of the regulatory regime for broadcasting — few of the innovative possibilities for digital TV or greater competition between broadcasters will be feasible. As noted previously, for some regulations it is easier to see the private than the public interest.

Dangerous 'cocktails'

Another source of (potentially) unintended impacts can come from the regulatory equivalent to adverse drug interactions. Regulations generally come not in ones or even twos, but as 'cocktails' with interactions that are often unforseen. For example, during the Productivity Commission's study of the Great Barrier Reef and related water catchment issues, some graziers expressed concern that drought relief assistance was reducing the incentive for some property managers to stock their properties conservatively so as to manage periods of climatic variability. Overstocking was in turn contributing to increased soil erosion and sediment discharges into rivers draining into the Great Barrier Reef lagoon.

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[2] It has sometimes been reported that excessively crooked cucumbers are *outlawed* by EU law, but this is incorrect. It is legal to sell bent cucumbers; it would only be crook to *label* them as straight.

Certain tax provisions for primary producers may also have contributed to declining water quality. For example, Landcare tax deductions can be claimed by rural businesses for some types of expenditure to combat land degradation, including for 'destroying plant growth detrimental to the land'. This provision, by creating an incentive for land clearing and the removal of regrowth, may have also unintentionally served to reduce water quality.

Sometimes the interplay of different regulatory requirements just produces confusion — risking non-compliance or simply contempt for regulatory processes. For example, at one point there were three different requirements in NSW for the distance from a watercourse at which earthworks could be carried out. The Department of Conservation and Land Management stipulated 60 metres; the Department of Water Resources said 20 metres; and the Department of Planning EIS guidelines, apparently in the spirit of compromise, proposed 40 metres (Sturgess 1994).

There is also ample scope for regulatory confusion *between* Australian jurisdictions, which poses problems for firms that span more than one. For example, for more than a century the States and Territories were unable to reach agreement on uniform national food regulation, with a national approach only being adopted after the Mutual Recognition Agreement was brought in. (This is why mutual recognition can be a powerful force for coherence and better compliance, as the Commission has reaffirmed in its current review. PC, 2003)[3]

The problem of regulatory overreach, or undue ambition

Regulation is often seen as the obvious response to imperfections in the market. However, imperfections in the market are ubiquitous. Firms typically have some market power; consumers have incomplete information; externalities abound. Rationales based on market failures or other imperfections are a necessary, but far from sufficient basis for regulation. In many cases, the costs and risks of regulation will outweigh the good intended from them — the best response to many imperfections will be to accept them as the lesser evil.

However, the requisite policy humility for such abstention is sometimes lacking. Regulation-optimists divine imperfection everywhere except in regulation. While the risks of overreach are apparent in many areas of regulation, one in which it has

[3] National standards have been developed within Australia for pressure vessels, dried fruits, eggs, gas appliance standards and transporting hazardous substances. Standards have also been harmonised for some occupations, including trans-Tasman standards for nurses and Australian national registration for lawyers.

been particularly apparent from the Productivity Commission's recent inquiries is competition policy.

The seductiveness of controlling 'market power'

There is a natural (and popular) tendency to urge greater regulatory control over perceived market power. Some manifestations of market power — of the endemic or obdurate kind that raises prices inefficiently for long periods — are worth stamping on. But other forms of market power are less clearly appropriate targets. It is one of the paradoxes of competition policy that the regulations recognise that intellectual property protection strengthens incentives for innovation (the Trade Practices Act exempts patents from action), but that high prices acquired through technological and entrepreneurial advantages can be seen as requiring policy 'remedies'. The regulation of mobile phone telecommunications services in Australia may be an illustration of the inappropriate extension of an access regime to what is a workably competitive market with multiple providers and reasonable entry potential (PC 2001a).

Nor does the existence of natural monopoly mean that hardline price regulation is necessarily required to produce acceptable outcomes. For example, in the case of airports, there are factors at work that reduce the risk that their latent market power will be used to inefficiently constrain airline use of airports. In particular, airports have the ability to price air services flexibly so as to increase airport capacity utilisation. And the potential magnitude of non-aeronautical revenue (retailing, car parking) also means that major airports have incentives to moderate their pricing of aeronautical services so as not to reduce passenger throughput and undermine total airport profitability.

The Commission accordingly recommended more light-handed regulation, involving a prices monitoring regime that carried with it the threat of more prescriptive pricing regulation if prices became excessive (PC 2002a). This recommendation was accepted by Government. In the short time since the regime has been operating it appears to have worked satisfactorily. Day-to-day regulatory involvement in investment decision-making has been removed — offering scope for long run improvement in services. Genuine commercial negotiations between airports and airlines are beginning. And initial price increases have reflected the efficient costs of supplying airport services. Since the test of a competition policy is its results (not its means), it could be maintained that prices monitoring met the requirements for an effective access regime for Sydney Airport.

That was not the conclusion of the NCC, however, which in response to an application by Virgin Blue has issued a draft recommendation for the declaration of

certain airside services at Sydney Airport under the National Access Regime (NCC, 2003). In the Commission's view, key parts of the NCC's assessment are unconvincing and require further consideration (see PC, 2003). Given the constraints on the inefficient exercise of market power posed by pricing flexibility, non-aeronautical revenue and the existing prices monitoring regime, it is unlikely that declaration would bring any additional benefits, whereas the potential costs of reinstating what will inevitably amount to heavy-handed regulation have already been demonstrated.

How much help does David need against Goliath?

Small business has an ambivalent relationship with regulation. On the one hand, as already discussed, small business bears the brunt of compliance burdens and is often (appropriately) sceptical of the need for, or application of, government regulation. On the other hand, they often call for regulation that assists them and, in particular, protects them from larger businesses. While there *are* grounds for regulations in this area, such as the unconscionability sections of the TPA, some mooted changes to the TPA risk undermining broader economic policy objectives.

For example, in its submission to the Baird Review, the National Association of Retail Grocers of Australia (NARGA) argued that the domination of the retail grocery market by several chains undermined effective competition. It called for a cap of 25 per cent on the market share of any one retailer, with mandatory divestiture to achieve that aim. Such regulation would be unlikely to achieve its objective, but it would almost certainly have the effect of curtailing efficiencies of scale and scope in grocery retailing, to the detriment of consumers.

Many existing regulatory measures appear to have as their intent the protection of small business interests at the expense of effective competition.

- When Boots threatened to enter the Australian pharmacy market in the late 1930s, this was strongly opposed by small independent pharmacies as a threat to their interests (BIE 1985, p. 39). Regulations barring chain pharmacies were introduced and are maintained to this day, as are a host of other regulations inhibiting competition in this key area of consumer expenditure.

- Shopping hour regulations — mostly now gone but still clinging on in some states — have arguably had the principal effect of reducing the competitive position of large supermarkets and other large chain stores to the detriment of consumers.

Small business is often a source of innovation and entrepreneurship, and a driver of productive change in the economy, *but not always*. Sheer numbers in an industry do

not equate with competition or dynamism, and should not be protected for their own sake (Banks, 2000).

A problem with using trade practices legislation to shift the balance of power in arrangements between big and small parties is that it may encourage firms to seek regulators (and then courts) to arbitrate in the distribution of gains in bargaining arrangements where efficiency considerations are not at stake. Such negotiating arrangements are ubiquitous in any thriving economy. Too easily wielded a regulation would invite bureaucratic and court intrusion into almost any commercial arrangement.

The point to emphasise is that regulatory measures to deal with bargaining imbalances do not come cheap. They impose compliance costs on firms and involve administrative costs for courts and bureaucrats. They can distort the size distribution of firms and inhibit efficiency. Regulatory and judicial mistakes will inevitably be made — which then have their own equity and efficiency consequences.

Section 46: is *it broke?*

Similar issues arise with the continued calls for inclusion of an effects test in section 46 of the TPA (abuse of market power), notwithstanding the findings of the Dawson Committee and several earlier assessments of this issue. This in part reflects small business concerns about the workability of section 46 in dealing with predatory pricing following the High Court's decision on *Boral Besser Masonry Limited v ACCC*.

The Productivity Commission's view, set out in its submission to the Dawson Review (PC, 2002d), is that while an effects test has some superficial advantages, its implementation would be likely to have adverse impacts on efficiency and the process of competition itself. In particular, an effects test would increase the likelihood of regulatory error — pointing the finger at behaviours that may be damaging to competitors, but that are merely a reflection of fierce, efficiency enhancing competition.

For example, predatory behaviour is often alleged but rarely observed (OECD, 1989). That should not be surprising. It requires a firm to be confident that the losses incurred in driving competitors out of the market will be more than made up subsequently through high ('supra-competitive') pricing — without losing market share again in the process. More than 'deep pockets' are required, unless future profitability and market power can be underpinned by credible deterrence of new entry. In the case of Boral, an effects test would not have helped anyway, as the High Court rejected the notion that the company currently had substantial market

power or that it would have recouped the losses sustained through price discounting (that is, that it would have sufficient *future* market power).

Other proposed statutory ‘fixes’ to section 46 in the light of the Boral case need also to be considered closely. There is a tendency to underplay the general effectiveness of the existing legislation and the evolving judicial approach to its interpretation. For example, while the ACCC (2003) rightly argues that the existence of substantial market power extends beyond markets characterised by monopoly or near monopoly, it is not apparent that the judicial interpretation of the existing statute suggests otherwise. Indeed, in the Boral case, the High Court appears to have made a sophisticated and nuanced assessment of market power that (legal verbosity aside) would do economists proud. They also usefully probed and applied the concept of recoupment of losses in assessing predation and have established an appropriate precedent on this concept for future cases.

The perils of distinguishing true predatory behaviour from beneficial rivalrous behaviour mean that the threshold for regulatory intervention *should* be high. The present requirement to show purpose (or *infer* it from observed market behaviour — a feature of s46 that its critics often neglect to acknowledge) usefully constrains actions against behaviour that in most cases actually benefits consumers.

That does not mean that section 46, or the Act more generally, is necessarily without imperfections. For instance, a possible Achilles heel of the section, hinted at by Justice McHugh in his judgment and more fully by Edwards (2003), is that even had the recoupment test been met, a predatory pricing action could not be successfully pursued if the relevant party did not have substantial market power at the *time* of the alleged conduct. In the Boral case that was of no consequence, as it turned out, but it has thrown light on a potentially valid weakness that should be investigated.

Regulatory culture and capture

There is clearly a need for regulators to have some discretion, to enable them to respond flexibly depending on contexts. But the greater the discretion that statutes allow, the more that regulatory decisions will require *judgment*, which will inevitably be influenced by the governance arrangements and incentives facing the regulator. This raises the prospect of regulatory bias and ‘capture’.

Originally, capture was seen in relatively simplistic terms as a regulator getting ‘too close’ to the regulated. Regulators deal frequently with the firms that they oversee, and therefore may tend to reflect their patterns of thinking and viewpoints. (In rare, egregious cases, kickbacks or expectations of future employment might accentuate

their sympathies). It has been alleged at various stages that regulation and its implementation in many areas (land zoning, environmental protection, broadcasting regulations and safety regulations) has been influenced by the industries being regulated.

Economically self-interested regulatory capture of this blatant kind seems pretty rare today in Australia — especially given much better controls over the accountability, transparency and governance structures of regulatory authorities. But there are other forms of influence, which can distort decision-making.

- *Government.* A major concern of many participants in the Productivity Commission's inquiry into gambling, was that some of the agencies responsible for regulating gambling were not sufficiently independent of government and its budgetary imperatives — showing more concern for financial probity than issues of consumer protection (PC 1999). Even where governance arrangements involve statutory independence, governments may still exert some influence because they provide funding and over time can determine the functions and therefore the power of the regulator.
- *Populism.* Everyone likes their work to be valued and regulators are no exception. However what is 'popular' may not be what is right. Thus an action that is popularly perceived to be profiteering by a large firm may inappropriately be subject to regulatory control, even if objectively efficient (for example, rewarding a past risky investment). A possible example is the valuation of assets by State and Territory utility regulators. Considerable effort is expended by regulators in demanding that regulated firms value assets in a prescribed way as a basis for cost models. However, regulators are often unwilling to use the resulting estimates as a basis for price setting if they imply upward adjustment of prices. Accordingly, downward adjustments are made until acceptable prices are realised. The ratio of regulators' finally used asset valuations has been less than half that of the initial valuation made by regulators (PC 2002b, p. 49).
- *Technophiles*. Where regulators are required to endorse or develop standards, they can be captured by those who value technology or elegant technological solutions for their own sakes. The high-definition TV debacle may partly reflect such technological exuberance.
- *Risk aversion.* Regulators face risks with asymmetric returns. It is rare that a regulator will be found deficient for over-regulation, partly because the costs are not generally or immediately apparent, but will often face censure if a low adverse risk *is* realised (eg death of a child on play equipment).
- *Precedent*. Regulators may be constrained by past decisions in which they have vested their reputation, and which firms have relied upon for key business

decisions. This may be one impediment to more investment-friendly administration of competition rules in the infrastructure area (PC, 2001b).

Even without such constraints and influences, regulators face a daunting task. It is expected that they should be SNARs — sensitive new age regulators — generally avoiding mistakes, being fair, informed, transparent, consultative, balancing interests, speedy, responsive and sensitive. When technology and market demands are changing rapidly — which is increasingly the case — the informational and decision-making difficulties for regulators multiply. The reality is that it is impossible to meet all of these imperatives simultaneously. Any expectation of zero regulatory error is naive and indeed dangerous. Administrative fallibility has some important implications. Fallibility needs to be taken into account when assessing the costs and benefits of regulations, especially where symmetric errors have asymmetric welfare effects; and when a regulatory mistake does occur it does not necessarily signal a need for further regulations or increased powers.

So what is 'good' regulation?

Defining what is good regulation is a starting point for doing better. To qualify, regulation needs to exhibit several characteristics (ORR 1998).

- *It must actually do good.* It must have a sound rationale and be shown to bring a *net* benefit to society, requiring costs as well as benefits to be brought into account.
- *It must be better* than any alternative regulation or policy tool. It is not enough to compare a regulation to a counterfactual of no regulation, but to compare outcomes across all feasible policy alternatives.
- *It must be robust to errors* in the assumptions underlying it. While portrayed as a dull bureaucratic process, many regulations could be more aptly likened to risky experiments. The regulatory appraisal process should take explicit account of the likely outcomes if the regulator turns out to be wrong about aspects of the effects of the regulation. Certain errors may completely overturn the gains from regulations and knowledge of these may make it sensible to re-design the regulation or, in some cases, not to proceed at all.
- *It should contain the seeds of its own destruction.* Good regulations should not presume their own immortality, but allow for ongoing appraisal of their risks and continued effectiveness. If a regulation endures, that should be because it continues to pass stringent tests.
- *It should state (ex ante) what it is going to do* and, as far as possible, establish verifiable performance criteria. This tests a regulation for precision and

relevance, and provides a basis for assessment of ex post effectiveness. If a new safety standard is approved for small boat safety, how many drownings and accidents is it expected to avoid? If speed cameras are deployed for reducing accidents do they do so and by how much?

- *It should be clear and concise*. It should also be communicated effectively and be readily accessible to those affected by it. Not only should people be able to find out what regulations apply to them, the regulations themselves must be capable of being readily understood.
- *It should be consistent* with other laws, agreements and international obligations. Inconsistency can create division, confusion and waste.
- *It must be enforceable*. But it should embody incentives or disciplines no greater than are needed for reasonable enforcement, and involve adequate resources for the purpose.
- Finally, it needs to be *administered by accountable bodies* in a fair and consistent manner. Governance arrangements for regulators are clearly a big topic in their own right and currently under review at the Commonwealth level. Apart from the nature of reporting responsibilities (to a Minister or the Parliament) and the scope for judicial or administrative review, important features of good governance include clear statutory guidance, transparency of both process and judgement, and public accessibility.

Working *with* the market

A major failing in past regulatory approaches was the assumption that if there was a market failure, then the appropriate mechanism for dealing with it was a non-market approach, typically 'command and control' approaches that were often highly prescriptive. The generally acknowledged goal now is to achieve the desired regulatory outcomes at least cost. This has facilitated a wider array of regulatory approaches, including recognition of the flexibility and information-richness of market-based mechanisms.

Market-based regulations can take various forms:

- incentive-compatible mechanisms (such as taxes, competitive tendering and emissions trading);
- mandatory information disclosure, with the threat of more heavy handed regulation and public disapproval (as in prices monitoring of Sydney Airport or hazardous waste disclosure in the United States); and

- self-regulation, where an industry must devise a workable regulatory approach to achieve accepted performance standards, with minimal prescription by regulators.

Economic incentives

Markets offer the potential for achieving regulatory objectives more efficiently than prescriptive regulations. For example, it is possible to make a reduction in some undesirable outcome or 'bad' (eg pollution) a market good in itself, bringing to bear the inventiveness and cost consciousness that characterises market competition. Regulations of this kind:

- can allow for the fact that the costs and benefits of regulation vary across firms, as well as over time. For example, discharge trading allows firms that are less efficient at lowering discharges to buy discharge rights from firms that are more efficient;
- allow firms the freedom to determine what technology is used to achieve a given performance standard or target; and, as a result,
- are informationally efficient, not requiring the regulator to know a lot about the technologies or costs of regulated firms. A well designed market creates incentives for individual firms to act on the information they have.

There is a plethora of economic instruments that are being trialed, particularly in the environmental area. For example, governments have begun to create markets for the environment by defining a new property right that is linked to the desired ecosystem service and can be exchanged for reward. Australian examples are the use of tradeable emission permits to limit saline discharges into rivers, and a trial of competitive tendering as a cost-effective way of encouraging landholders to supply conservation of biodiversity on private land for profit (the Victorian Government's BushTender trial — see PC, 2002c).

Overall, carefully designed and prudently applied economic instruments offer great promise of achieving better regulatory outcomes at lower cost. As with other new forms of regulation, however, it is sensible to adopt incremental reforms and undertake small scale pilots before their widespread application.

Self- and co-regulation

Self-regulation has the virtue of allowing much greater freedom by an industry about the 'whats and hows' of regulation, including dispute resolution. It economises on administration costs to government and utilises specialist industry

information more efficiently than command and control type rules. Self-regulation is used widely (advertising, real estate, financial services, telecommunications, many professions, and funeral directors). It is not appropriate if compliance with performance standards cannot be readily verified, or if penalties are too weak relative to the costs of poor performance, or dispute resolution poor (ORR, 1997). But where these criteria are met, self-regulation can be a cost-effective alternative to government intervention.

Some apparent self-regulation is actually *co*-regulation, in that government still acts as a monitor and enforcer of some transparent performance criteria. For example, an industry code can be prescribed under the TPA, making the code law and creating the potential for damages, court orders and injunctions as remedies for breaches (the Franchising Code of Conduct is an example). Most recently, the ACCC has developed a complementary and light-handed role for self-regulation in consumer issues, which invokes less severe penalties than those obtainable through section 51AD of the TPA (which, in any case, has hardly been applied). This certification strategy is an innovative initiative with the potential to avoid more heavy-handed regulations and yet achieve good outcomes for consumers. Clearly, as for other forms of regulation, it will need to be evaluated for effectiveness over time.

Good process is fundamental

Many of the conceptual and practical underpinnings for better regulation are now established. But that is not enough. Bad regulation is tenacious because the governance arrangements for regulation-making are still far from perfect.

The adoption of more stringent ex ante assessment processes by regulators, together with independent verification of their use, can make a significant difference — as in the Regulatory Impact Statements required at the Commonwealth level and overseen by the Office of Regulation Review (ORR 1998). Improved transparency and independent assessment can also help provide greater discipline on regulation-making.

The fact of regulatory fallibility suggests that there should be appropriate checks and balances (including merit reviews) and clear statutory guidance for regulators. Regulators also need to consult much more widely about the potential effects of regulations (particularly compliance costs) and ensure that regulations are regularly tested for continued relevance and cost-effectiveness.

Regulatory norms also need confronting. If nothing else, the risks and failures associated with the regulatory endeavour, of which I have only mentioned a few —

should cool the ardour of those for whom every problem has an apparent regulatory fix. Regulatory forbearance is likely to be an appropriate stance in situations in which market outcomes are only a little bit imperfect.

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