Regulating in the Digital Economy

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Thank you…

A lot has been said about what digital disruption means for business, but much less on what it means for governments and regulators.

So it is very positive that conferences like this one are taking stock of how the digital economy impacts on governments and regulators.

My remarks this afternoon will focus on addressing two of the questions for this session:

'How does digital disruption bear on regulatory policy?'

And second, 'What are the implications for the design of regulatory institutions, without stymieing the innovation opportunities that digital technologies offer?'

But, before continuing, I suspect some of you are wondering what is the Productivity Commission and what does it have to do with digital disruption?

So I will first say a little bit about the PC, the role we play and how we operate.

The Productivity Commission is an independent research and advisory body on economic, social and environmental issues to the Australian government.

Our objective is to support well-informed *policy decision-making* and *public understanding* on matters relating to Australia's productivity and living standards.

Our approach applies an economic framework with 'fresh eyes'. In other words, often we take a step back to ask not just whether or not something could be done better, but whether it should be done at all.

The core of our work comes through terms of reference from government for Commissioned inquiries or studies.

We also have statutory reporting requirements, such as on industry support.

And we can self-initiate research projects.

Ultimately, we like to think we contribute to better policies in the long term interest of the Australian community.

This slide showing the recent projects we have reported on gives you an idea of the breadth and diversity of topics we cover.

A number of them look at the broad challenges and opportunities created by the digital economy and at what institutional and regulatory settings by the Australian government would be most effective.

They include a research study on '**Digital disruption: What do governments need to do?**'

Another was released earlier this month on **Growing the digital economy in Australia and New Zealand: maximising the opportunities for small and medium sized enterprises.**'

These are the reports that I want to turn to now to address the key questions and issues of this session.

In doing so, I also hope that it offers a worked example of how the Productivity Commission as an institution, itself contributes to policies that promote higher productivity and living standards.

Reflecting the Commission's broad analytical lens we do not as a rule dive deep into the *specific* design of regulatory institutions or regulations.

Maybe this will disappoint some of you who are looking for detailed answers to the questions posed for this session.

However, often the route to achieving better policy outcomes is a process that starts by enhancing public awareness of the issues, identifying the challenges and the opportunities.

The aim of our report on **Digital disruption** was precisely to stimulate a discussion within and among governments and their agencies on what they do and how they do it.

Today, I will concentrate on the issues as they relate to regulators and the regulated.

Before getting into specifics, I have two general observations.

The **first** is to avoid thinking of the digital economy as a separate sector, or that it is somehow different from the rest of the economy.

It is not. The digital economy *is* the economy.

These days, few activities in a modern economy are unaffected by digital technologies. This is true on both the demand and supply sides of the economy.

On the *demand side*, for example, nearly two thirds of consumers purchase at least some goods and services online, and the share is rising.

And on the *supply side*, digital is almost ubiquitous, with for example 95 per cent of firms using the Internet.

Of course, the extent of digitalisation, or use of digital technologies differs greatly between industries and firms.

While I consider the digital economy as conceptually no different from the broader economy, some of the implications of disruptive digital technologies are quite specific.

For example, digital platforms can exhibit network effects, which may entrench incumbents or lead to 'winner-takes-most' dynamics.

Some argue that these dynamics create an incentive for platforms to pursue growth over profit and engage in predatory pricing.

Price setting by algorithms could also lead to anticompetitive outcomes, which may be difficult to detect and may be legal under current laws, because they do not involve an agreement to fix prices.

Digital technologies also bring many benefits, some of which are not reflected in GDP, our standard metric of an economy's size. They include greater choice, lower prices and better information.

Similarly, they can bring disruption on a potentially greater scale than in the past and new harms, requiring different regulation and possibly different compliance strategies. More on that later.

My second general observation is to always try and keep a sense of perspective.

As Bill Gates said 'We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next 10. Don't let yourself be lulled into inaction'.

This advice from Gates was directed at businesses, but it applies to regulators too.

We have already seen how a decade of digital technology has disrupted the entertainment, media and retail businesses in ways few anticipated.

However, in other sectors, such as health and education, the potential for digital technologies, especially through the use of data to improve services and market functioning is yet to materialise by anywhere near to the same extent.

This has implications in terms of foregone productivity gains, which I will get to later.

But it also gives us time to learn from the lessons when regulation is outdated or slow to catch up, and hopefully to avoid repeating our mistakes.

Taxi regulation is a case in point.

The disruption was a digital technology that dramatically reduced the cost of matching in real time a taxi with where the demand for taxi services is.

It meant that drivers spent proportionately more of their time on the road with a paying passenger. It was also more convenient for the consumer. And the design of the platform offered tools, such as transaction histories, feedback, and verification of identities to establish and maintain confidence and trust for both the driver and the customer.

The new technology posed truly fundamental questions for regulators, notably who to regulate, what to regulate and how to regulate?

This slide shows some of the initial regulations, or proposed responses to the emergence of Uber and other digital platforms offering taxi services.

There is little evidence that these responses stemmed from asking how the platforms may have changed the who, how and what to regulate.

The common theme was closer to measures that punctured the cost savings or productivity gains from the digital platform.

Why should an Uber car need to return to depot after each job? In fact what is the meaning of a depot for an Uber driver?

Some of the proposed measures effectively tried to ban the technology itself. For example, in France, where making a booking by GPS would be illegal.

Other countries, for example Indonesia were under pressure from incumbents to ban the Apps altogether.

The majority of the measures were in effect designed to limit competition, by creating artificial barriers to entry, minimum price fixing or adding to costs.

In the end, most of these measures were not implemented or only lasted for a short period of time.

And to be fair, there was a lot of pressure for regulators to respond quickly, not least because Uber were unwilling or impatient when engaging with regulators.

Taxi services in many countries complained that slow moving regulatory regimes and the lack of regulator coverage of Uber and other ridesharing services placed taxis at a competitive disadvantage.

However, taxi regulation is not a unique example.

Digital technologies are putting many existing regulatory regimes under pressure.

The development and diffusion of digital technologies is arguably advancing at a faster pace than regulators can manage.

Moreover, while earlier industrial revolutions primarily transformed production processes, the digital revolution is also transforming consumption and transactions.

It is creating new goods and services from video streaming to driverless cars that current regulatory regimes did not, and could not anticipate.

Some of these new goods and services fall across multiple regulatory regimes.

For example, a review of regulation affecting the introduction of driverless vehicles in Australia identified 716 legislative barriers that would need to be overcome (National Transport Commission).

This large number of barriers was due to multiple layers of regulation, at state and territory, national and international levels and the fact that many of the Australian laws explicitly require a driver to be present in a car and able to take over controls.

Digital technology is also enabling cross border transactions that are not adequately covered by national regulation, such as consumer law, or where regulation differs significantly between countries, such as privacy law.

Many regulators are playing catch up in a digital world, and this can create an uneven playing field that either incumbents, or less often, new entrants can benefit from.

All too frequently, the response of regulators is to focus on how the innovative activity or new technology can be integrated into the existing regulatory framework.

They fail to take a step back and ask whether the innovation bears on the rationale for regulation in the first place.

And they pay little attention to whether regulation gets in the way of innovation, or whether digital technology offers ways to lower the costs of compliance.

This is not to say that the digital economy (and digital platforms) will do away with regulation.

Rather, it will change how we regulate, what we regulate and how we enforce regulation. And sometimes profoundly.

In this new environment it is important to ask and ensure that regulation remains fit for purpose. It is a question for governments and regulators alike.

It is important because investment in new industries can be frustrated by poor regulation, the protection of incumbents, and the absence of complementary policies, for example, in relation to standards and data access.

Unintended distortions, such as changes to incentives to invest or innovate, or the introduction of barriers to adopting new business models, can be costly to the economy and it is these unintended costs that loom large when regulation is outdated or slow to catch up.

In short, a failure to maintain fit for purpose regulation affects the ability of new firms to enter markets and for new technologies to diffuse throughout the economy. It may also put individuals in harm's way and impose unnecessarily high compliance costs.

The digital economy *also* offers opportunities to regulators and the regulated.

For example, digital platforms reduce information asymmetry because of lower search costs and aggregators facilitate product comparisons favouring stronger competition.

This may make some regulation redundant.

There is also enormous scope to use digital technologies to monitor and improve compliance and to design regulatory solutions better tailored to risks.

For example, sensor technologies could facilitate enforcement strategies, such as automated warnings or the remote disabling of services.

So you can see that the digital economy is not just a one way street. It brings forth challenges, but it also has huge potential to make regulation more efficient and to reduce the burden of regulation on businesses and citizens.

Ultimately, given intrinsic characteristics and differences in risk profiles, a case by case regulatory response to new *supply* models is required.

So, in more concrete terms what do digital technologies imply for how regulators regulate?

We argue it *reinforces* the case for regulators to adopt a **risk-based, outcome focused approach**, as this gives the greatest return to regulatory effort. This means focussing on regulatory outcomes, not the technology.

The other dimension is the need for **closer engagement with the regulated**. This means ensuring firms know what they need to do, and providing the flexibility to let firms try new ways of doing business.

However, regulators do not always have the scope within their legislation to act flexibly. Or their culture simply does not foster a risk-based approach with closer engagement with the regulated. This will need to change.

Certainly, giving regulators permission to experiment wasn't done well with respect to Uber and taxi regulation.

Indeed, denial was a principal mode of transition for many years in the case of taxis. In the end, technology proved the ultimate reformer.

If denial again dominates thoughtful transition, it will further reduce community confidence in the far-sightedness of regulators.

But there have also been exceptions. One is FinTech.

The financial services sector is one where policy makers and regulators cannot afford to maintain a business as usual attitude to regulation.

My impression is that this point is well understood. There is evidence of forethought being given to Fintech, and a genuine recognition of the important contribution Fintech offers to consumers.

For example, innovative regulatory tools, such as a **regulatory sandbox** are being tested. This is where a new approach is tested in controlled conditions to identify risks before deciding on general deployment - a quasi sort of Randomised Control Trial.

There is also a need for greater international co-operation. Here another positive example is in the area of digital trade.

Recent regional trade agreements, such as the TPP do include provisions covering areas such as cross-border data flows, cloud computing and data localisation.

Multilateral trade agreements will need to catch up, but clearly this is not an easy task in the current environment.

So what does this boil down to from a regulatory institution perspective?

I am not in a position to be prescriptive. As I said earlier, it's not the role or competence of the Productivity Commission to do that.

But our work has revealed the traditional principles of good regulation remain highly relevant.

Regulators should constantly ask themselves questions like whether regulation is getting in the way of innovation. Are digital technologies empowering consumers?

Or do they provide new sources of information for regulators and offer ways to lower the costs of regulatory transactions?

More broadly, *governments*, especially where market forces are driving rapid change, should make sure that regulation or its actions allow competition to unfold.

Governments should also equip regulatory agencies with the tools necessary to carry out their mandates. This may involve bringing existing regulation regimes closer together or involve regulators taking on new roles.

So really what I am saying is to ensure regulations remain fit for purpose. And if they are not fit for purpose, the regulations and compliance strategies should be updated.

Of course, this is easier said than done. But nor are the challenges new, they just manifest themselves in different ways.

What is new is the speed and breadth of change. And some challenges are particularly difficult to overcome, including, for example, how to apply consumer law to digital and cross-border transactions, or how to address the market power of global platforms.

Evidently, greater co-operation between regulators, including across borders would be beneficial.

Embedding good practices and learning from past mistakes, such as with taxis will go a long way to put regulators in a good position to respond to inevitable changes, be they from digital technology or otherwise.

Up to now I have focused on how digital technologies are forcing change on regulators. The *supply side* perspective.

But, arguably an equally big, possibly bigger driver of change is coming from the *demand side*.

For example, we have already seen how consumers are forcing retailers and media companies to reform.

We also know young recruits and talented employees are attracted by things like how businesses foster a collaborative working environment, or espouse certain values, such as environmental sustainability, alongside traditional concerns like wages.

The common element of the changes we are seeing is that they are being driven by individuals, whether they be consumers, workers or students.

Armed with the power of data they are exercising their choices and driving changes.

However, as I noted earlier, change from the digital revolution has been slower in the non-market sector of the economy.

It is illustrated in this slide, taken from a 2012 Deloitte report, by the sectors sitting in the top right hand quadrant.

Digital technologies in the education sector, for instance, are expected to be as disruptive as for the media and retail sectors, but the lead times needed to diffuse the technologies and deal with regulatory barriers are longer.

Improved access to data may speed up the effective deployment of new technologies.

In a recent PC report on 'Data availability and use' we argue that consumers can be empowered to use their data to strengthen market forces and competition.

Data and its analytics is the most significant renewable resource discovered this century. But it is a resource that is manifestly underutilised.

The health sector is a good example and another large sector in the top right hand of the previous slide. It illustrates well how data frameworks and protections, developed prior to sweeping digitisation need reform.

In Australia, for example, communication between doctors and specialists or with hospitals *must* pass by facsimile machine.

It is another case of regulation specifying the type of technology that has long become outdated. Yet at the same time, hospitals are big users of sophisticated technologies.

Another irony is the higher the degree of medical specialisation, the less the uptake of computer technology.

These dynamics could change.

A central plank of the Commission's report on data availability and use is an overarching data access law (a Data Sharing and Release Act) that would give consumers a Comprehensive Right to access their data and direct that it be provided to third parties.

This would enhance competition by enabling consumers to have their data transferred to potential alternative suppliers. For example, data that accumulated over years, by their bank or telecommunications company.

The ability to drive competition in this way would significantly increase in value, as data collection continues to grow. But the benefits of the Comprehensive Right could extend beyond competition between existing providers by enabling further innovation in products and services.

It also has implications for the relevant regulators to ensure upfront standards for safe, pro-competitive data transfer are offered, and to provide avenues for complaint and redress in the event of breaches.

In short, it is a radical change, which is being implemented and just another reminder that the digital economy *is* the economy.

Thank you.