Australian Competition & Consumer Commission

New Agenda for Prosperity conference

Dealing with the regulatory burden: the participants and their incentives

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Why is regulatory review needed?

Most of the time markets work best if competition is allowed to operate. Competition aligns the interests of consumers and producers. Consumers want products that best meet their needs at the lowest prices. Producers maximise profits by meeting those needs in the most efficient way possible.

At the same time, markets do not operate efficiently in a legal vacuum. Regulation is necessary for a functioning market economy. Regulations and laws relating to property rights, contracts and the obligations of market participants assist the smooth flow of commerce.

In some circumstances, it is socially desirable for market regulation to go further. For example, product safety rules are generally accepted as a desirable part of the market economy and often are preferable to pure 'caveat emptor'. In some sectors, monopoly rather than competition is the likely market structure and regulation may be needed to either improve competition or limit monopoly harm.

Because markets need a range of regulation, the process of regulatory design and review is an ongoing task. Good regulation is often difficult to formulate. Legislation is often open to varying interpretations. As a result market participants and regulators may have legitimate but different views about the exact implications of certain regulations.

Courts may be called upon to adjudicate specific disputes, but appeals to Courts can be costly and time consuming and Court precedent may provide only limited guidance for future regulatory disputes. Regulation needs to be regularly reviewed in the light of such disputes to ensure that it is still functioning appropriately.

Even if regulations are appropriate when they are first enacted, changes to both the nature of the Australian economy and to our understanding of the interaction between regulation and commerce means that regulation needs to be regularly reviewed. For example, the simple form of rate-of-return regulation for utilities that was 'state of the art' in the mid 20th century is now recognised as out dated. Modern incentive regulation is used to ensure better performance from privately-owned utilities in energy and telecommunications.

Regulation also tends to expand over time. When the limitations of rules and regulations are recognised by market participants, regulators or Courts, legislators have a natural tendency to try and 'repair' the existing regulations by adding further wording. Of course, as each loophole is closed another tends to open, resulting in further amendment. This growth in regulation in Australia was noted by the Taskforce on Reducing Regulatory Burdens in Business. In its report the Taskforce stated that:

> The volume of regulation has grown dramatically in recent years. For example, since 1990, the Australian Parliament has passed more pages of legislation than were passed during the first 90 years of federation.[1]

Regulation is often promulgated as the result of a specific crisis. For example, financial regulation has often been written on the back of cases of corporate malfeasance. The collapse of Enron led to significant new (and in some views, onerous) financial regulation in the United States. The current sub-prime controversy has led to calls for the reintroduction of some version of the Glass-Steagall Act in the United States.[2]

The changing nature of our economy and the naturally tendency for regulation to grow over time mean that both regulatory review and pruning are necessary. However while it is often easy to promulgate new regulations, reforming sub standard regulation or removing unnecessary regulation often faces a range of significant barriers.

Barriers to regulatory reform

There are three main participants in the regulatory process: business, the public through their elected representatives, and the regulators. Each of these groups can assist in regulatory reform. However each of these groups may also created barriers to regulatory reform.

The regulators

First, as Commissioner in an independent statutory regulatory agency, let me start by considering the role of regulators in regulatory reform. Regulators may be either a driving force for regulatory reform or a barrier to reform. A regulator's job is to enforce the regulation. Unsurprisingly many regulators like regulation. In particular, many regulators like the existing regulations. Existing rules are understood by the regulators and it is much easier to enforce long-standing rules and regulations than to grapple with new rules and regulations. Reforming regulation can make life hard for regulators. Eliminating regulations makes regulators redundant. As a result regulators may either actively or passively oppose regulatory reform.

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[1] Taskforce on Reducing Regulatory Burdens for Business (2006) *Rethinking Regulation*, Report to the Prime Minister and Treasurer, Canberra, January at p.5.
[2] For example see The Economist (2008) *Heart of Glass*, (Buttonwood column), January 31.

Good regulators need to continually review their operations to ensure that they are enforcing the relevant rules with a minimum burden to industry. In this way, regulatory reform becomes part of the regulator's business.

The ACCC's ongoing reform to its merger review processes provides an example. In recent years the ACCC has worked to improve the speed of merger review, the transparency of the review process, and communication to the business community and the broader public. In the 2006- 2007 financial year the ACCC reviewed 390 mergers. Of these mergers around 70% were completed in less than four weeks, with many of these completed in less than two weeks. The ACCC balances transparency with the legitimate need for business confidentiality. Thus business can seek a confidential merger assessment from the ACCC, noting that any outcome of such a confidential review will be subject to confirmation of the veracity of the information provided initially confidentially to the ACCC once the merger becomes public. During a public merger assessment the ACCC keeps all submissions confidential but has ongoing discussions with relevant parties about any preliminary concerns and about information that can be provided to either validate or counter those concerns. The broader business community is kept informed through a Statement of Issues when the ACCC has preliminary concerns about a merger. The ACCC also provides feedback to the business community by publishing Public Competition Assessments (PCAs) on a variety of completed merger reviews. Most recently, the ACCC has issued new draft Merger guidelines to better inform the business community about how it evaluates mergers and to receive feedback on its approach.

The draft merger guidelines have been developed with extensive and on-going consultation, including with the business community. Considered and transparent processes to review and reform regulation are vital to optimise the costs and benefits of regulations.

Most regulators should be unobtrusive most of the time. Some regulation will always be needed. But generally regulation should act like a foundation to the market system: critical in its effect but hidden below the day-to-day activity of the market. When regulation has an ongoing role to play in a company's operations then compliance should be straightforward. Ongoing regulation should be the corporate equivalent of a quarterly car service rather than a major automobile accident. When regulation aims to deal with corporate malfeasance, regulators need to act swiftly and appropriately in a clear and transparent way to either rectify the problem or bring the business concerned before the relevant authorities.

Regulators risk undermining good regulation when they seek to move themselves from the chorus line to centre stage. As the Taskforce noted;

> [A] number of business groups argued that the behaviour of regulators can be just as problematic as the regulations themselves. Issues commonly identified include heavy-handedness and undue legalism; failure to use risk assessment when determining how stringently or widely to enforce a regulation; poor and ineffective

> communication; and a lack of certainty and guidance to business about compliance requirements.[3]

In this sense, regulatory reform requires that regulators themselves adopt a culture of rigorous but low-burden compliance.

The law makers

Haste leads to bad regulation. Often when there is a crisis, for example in financial markets or due to a rapid change in the price of an important internationally traded commodity, lawmakers come under considerable pressure from the public to 'do something'. Often this 'something' involves introducing new regulations on business. Some examples of financial regulation were noted before. Similarly, many governments around the world are currently under pressure to 'do something' about petrol prices due to the rising cost of oil. Many governments are also being pressured to 'do something' because of the low price of many manufactured goods imported from China.

The taskforce noted these pressures on lawmakers.

> In the Taskforce's view, a fundamental driver is increasing 'risk aversion' in many spheres of life. In effect, regulation has come to be treated as a panacea for many of society's ills and, in particular, is seen as an easy means to protect people against an array of risks – big and small, physical and financial – that arise in daily life. Reflecting this view, a failure by governments and their regulators to 'do something' in response to the crisis of the moment often brings criticism from political opponents and in the media.[4]

The old saying "act in haste, regret at leisure" applies to the formulation of regulation. Lawmakers need to carefully weigh the costs and benefits associated with any new regulations including the compliance costs that face business.

Regulation is sometimes viewed by lawmakers as if it were a free lunch. Introducing new regulations often appears to be a simple quick fix for a problem. Unfortunately, consumers and the business community inevitably bear the costs of such quick fixes.

The solution to this political problem is outside my own area of expertise. However in Australia at the federal level we have been fortunate in recent years to have governments that have not overreacted to short term crises. Instead, government has turned to expert bodies such as the Reserve Bank, the Productivity Commission, and the ACCC to determine both the nature and extent of any problem before acting.

Business

[3] Op. Cit note 1 at p.7.
[4] Op. Cit note 1 at p.14.

The burden of regulation is often directly borne by business. In this sense the business community as a whole has the most to gain from regulatory reform. However, the benefits of reforming regulation are often diffuse while the benefits of maintaining regulation are often directly received by specific businesses. In this sense specific businesses often have the most to lose from the reform or elimination of regulation. As the Australian Consumers' Association noted in its submission to the Taskforce:

> Despite complaints about 'rising red tape', businesses are very selective in the criticisms of regulation. Protected industries (pharmacy, broadcasting, airlines, taxis, the professions) fight tooth and nail to keep the regulations which insulate them from competition.[5]

Regulation creates new business opportunities. Whole industries can grow on the back of burdensome regulation as lawyers offer their sage advice, accountants proffer the appropriate numbers and handle the multiple sets of accounts required by firms, economists provide critiques before regulators and courts, and various lobby groups push for their particular interest group before the legislators. With millions of private sector dollars riding on the continuation of dubious or burdensome regulation, it is unsurprising that regulatory reform often hits a private sector brick wall.

Regulated firms may also benefit by gaming regulation and such gaming is often easier when regulation is ambiguous or, in the quest for fairness, provides numerous routes for affected firms to appeal regulatory decision. For example, when regulation aims to increase competition, an incumbent firm has a strong incentive to slow down the progress of regulation. In this sense, it is unsurprising that Telstra – while complaining about the burden of telecommunications regulation and the decisions of the competition regulator, the ACCC[6] - currently has 48 regulatory decisions under appeal. Even if Telstra fails in all these appeals, the appeal process itself slows down the progress of competition in the telecommunications sector, benefiting Telstra as the incumbent owner of the public switched telephone network.

Because business has a vested interest in unnecessary regulation that limits competition or burdensome regulation that can be gamed, certain businesses can be the biggest barrier to specific regulatory reform.

Reforming regulation

For regulatory reform to be effective, business, lawmakers and regulators must be aligned in their aims for such reform. In Australia, governments have been successful in overcoming the incentives for unnecessary regulation through the COAG process, and in particular, through the National Competition Policy program of the 1990s. This process is to be updated and pushed forward through the leadership of the new federal government.

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[5] Op. Cit note 1 at p.15.
[6] See for example the various articles on Telstra's www.nowwearetalking.com.au website.

Regulators need to adopt a reform culture. This is, of course, easier said than done. However, government can assist with this process through its regulatory oversight. Too often regulators perceive that they are evaluated on a 'worst case' basis. This is the regulatory equivalent of 'no one ever got fired for buying IBM'. It leads to excessive regulatory conservatism and a tendency of regulators to increase the burden on regulated firms. As the Taskforce noted:

> [T]he risk aversion exhibited by regulators, which business groups rightly see as a root cause of many of the problems they experience, is to be expected in an environment where any adverse event within the regulator's field of influence is held up publicly as a 'failure', while any beneficial impacts on market performance that a regulator may have are not directly observable and go unremarked. Hence the incentives facing most regulators are to err on the side of being strict in their enforcement activities.[7]

Lawmakers need to provide appropriate guidance to regulators to avoid a risk averse culture and to ensure that regulators appropriately analyse the costs, benefits and risks associated with the regulations they implement.

The Taskforce provided a range of recommendations that can assist lawmakers and regulators to become agents for regulatory reform. These are outlined in chapter 7 of its report.

Business however also needs to be included in the process of regulatory reform. For example, if business wants to reduce the burden of regulation then it must work with the relevant regulators and recognise the incentives of their own advisors. In particular, business needs to recognize that private sector advisors may have incentives for regulatory conflict rather than regulatory solutions. Too often at the ACCC we find that advisors seek a 'win' that will enhance their professional reputation rather than a solution that will be of benefit to their client.

Business needs to recognise that there is a cost involved in regulatory review. While some businesses would like to draw out the regulatory process through successive reviews and appeals when they face an undesirable regulatory decision, the business community needs to recognise that this same incentive, when it works through the business community, risks tying industry in legal knots. In this sense, business faces a classic prisoners' dilemma with regulatory appeals – it is in each firm's interest to extend its own regulatory process even though this makes business as a whole worse off when all firms act the same way.

Regulatory decisions must be subject to appropriate review. But lawmakers need to recognise the costs of such review and provide strict but appropriate limits on the extent of such review.

Regulatory reform will always involve winners and losers. Relevant parts of the business community need to work with government to move forward with

[7] Op. Cit note 1 at p.159.

appropriate reform in a way that limits the burden on the losers. In the absence of such cooperation, governments need to show regulatory leadership. This means that governments must abide by strict cost-benefit protocols when creating new regulation. It also means that governments should apply these same protocols in an even-handed way when reviewing existing regulations.

The ACCC believes that competition within the market is the best means of achieving the greatest welfare benefits for Australians. Indeed competition underpins the Trade Practices Act. However, it has to be recognised that intervention in some markets is required before market disciplines can be relied upon to achieve the efficient use of resources. Here regulation – appropriately developed and subject to on-going review – can play a valuable role.